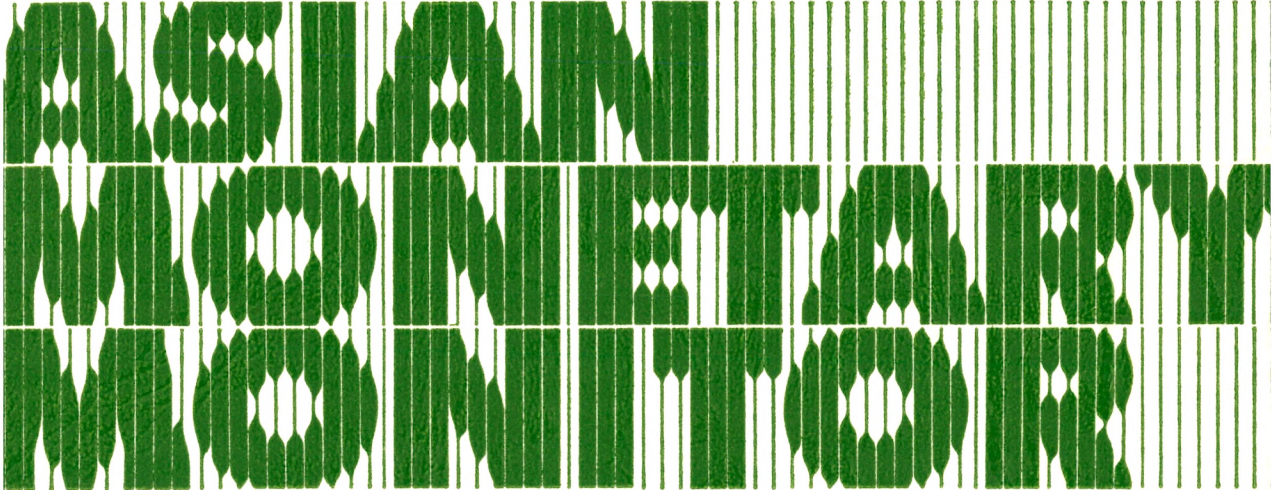




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Australian Dollar
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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of
preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

JAPAN

WHY THE CONSENSUS FORECAST FOR THE YEN WILL PROVE MISTAKEN

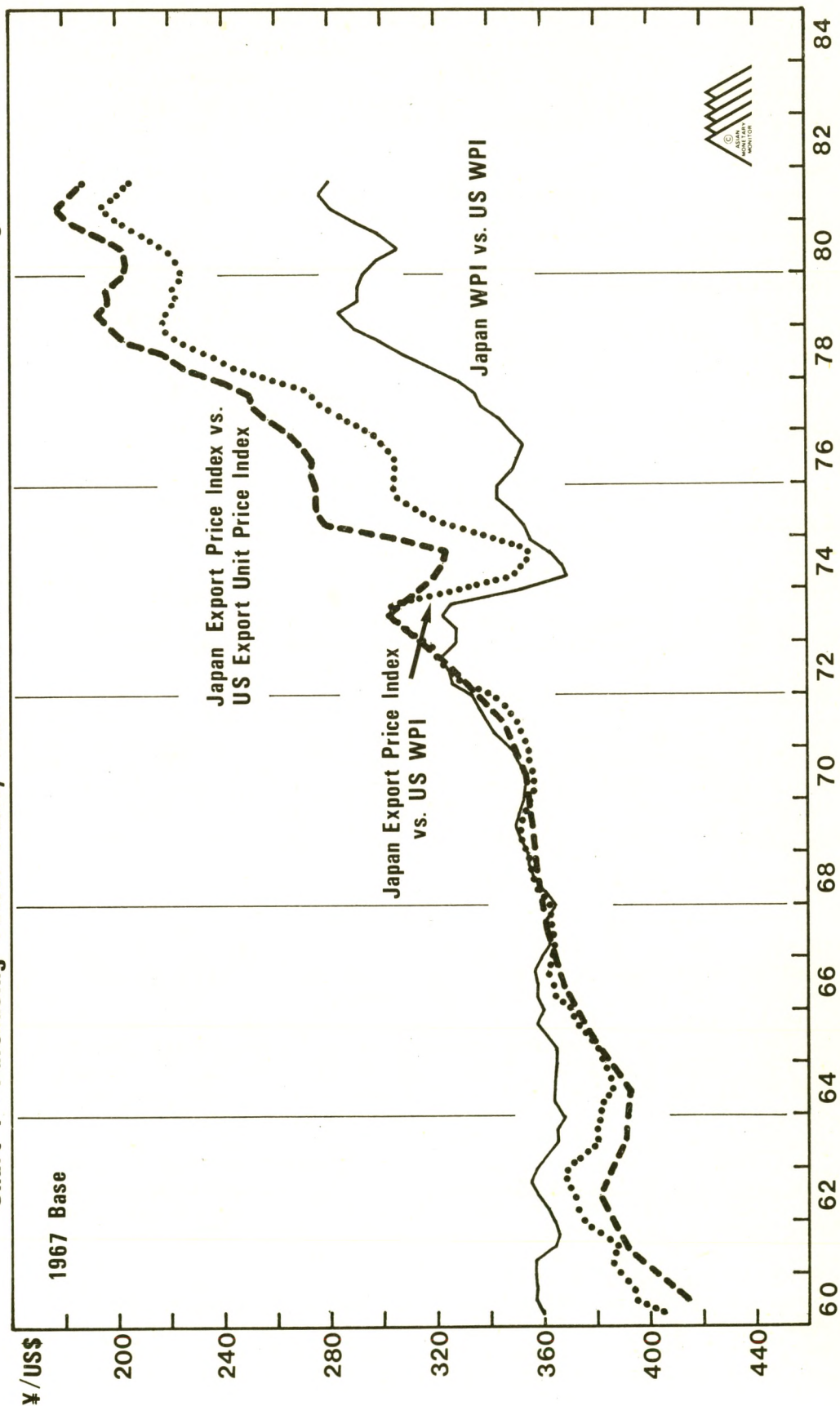
In the course of the past year the yen has tended to weaken against the US dollar. From a high of approximately ¥200 at the beginning of January 1981, the yen declined to below ¥240 for a brief period during August before appreciating to around ¥215 in December. The relative performance of the yen during 1981 proved a major disappointment to a majority of currency analysts who had expected the yen to trade strongly on the foreign exchanges.

At the start of 1982 it would appear that the consensus view of the yen's prospects is, once again, optimistic. The arguments supporting this view certainly look forceful. Key amongst them is the continued low level of inflation in Japan. In spite of a weaker yen/US dollar rate in 1981, Tokyo consumer prices rose a moderate 4.3% in the year to December whilst wholesale prices increased by a modest 1.6%. Although US inflation also declined during the year, Japan's inflation record continued to improve relative to that of the US. The implications of this for the long term trend of the yen/US dollar rate are suggested by the Purchasing Power Parity indices constructed in Chart 1, which also illustrates the relative performance of wholesale and export prices in Japan and the US. Purchasing Power Parity theory argues that the long term trend in any exchange rate is determined by the price competitiveness of goods produced or, strictly, goods traded by the two countries involved. Thus the indices depicted in Chart 1 suggest that providing we assume that the yen/US dollar rate was broadly in "equilibrium" during 1967, the selected base date for the three series, there has been a fairly sustained improvement in Japan's price competitiveness during the 1970s. This provides the rationale for the long term strength of yen during this period. More important, insofar as the medium term prospects for the yen are concerned, the yen/US dollar rate is currently some 10% to 20% below the value implied by Purchasing Power Parity analysis (see Chart 2). It is this which has led many observers to conclude that the yen is substantially "undervalued" against the US dollar at its present level.

A second consideration which provides grounds for optimism for the yen is the massive improvement in Japan's external account during 1981. By the end of 1981, Japan enjoyed a record balance of trade surplus, which pushed the current account from a deficit of US\$7 billion in fiscal year 1980 to a surplus of around US\$7½ billion during fiscal 1981. It is widely anticipated that Japan's external account will continue to strengthen into fiscal 1982. Official forecasts for Japan's current account call for an increase in the surplus to at least US\$10 billion by the end of the year, whilst some private forecasters are projecting a surplus of over US\$15 billion in fiscal 1982. Chart 3 illustrates the historical relationship between the broad trend in Japan's balance of trade and current accounts and the yen/US dollar rate, and it

JAPAN

Chart 1 : Purchasing Power Parity Indicators for the Yen - US Dollar Exchange Rate



is apparent - especially in the period between 1975 and the end of 1980 - that Japan's external account has been an important factor in determining the strength of the yen against the US dollar. The relationship between the yen rate and the current account broke down, temporarily, it is argued, during 1981, because of the adverse impact of high US interest rates on Japan's capital account and hence on the overall balance of payments. With the US economy currently in recession some forecasters are predicting a decline in US interest rates during the course of the year, a consequent reduction in capital outflows from Japan and the re-establishment of the strong positive correlation between a current account surplus and an appreciating yen. It is argued that this will be assisted by an improvement in Japan's overall terms of trade because while Japan's manufactured export prices should remain firm, oil and other commodity import prices will be under downward pressure.

Optimistic forecasts for the yen also highlight the view that a stronger yen is in keeping with the Japanese government's overall economic strategy. An appreciation of the yen would help to quell the trade frictions that have been a feature of recent official bi-lateral trade discussions by reducing the demand for Japan's exports and stimulating domestic demand for foreign goods and services. A firm yen might also enable the Bank of Japan to encourage the lack-lustre recovery that is now underway in the domestic economy through a further reduction in the Official Discount Rate.

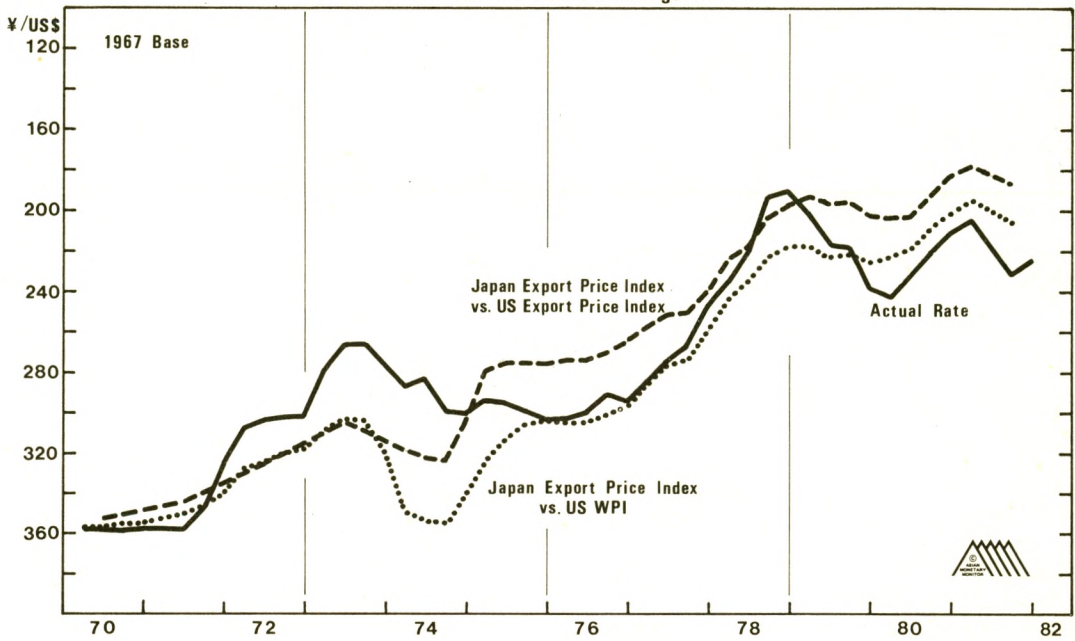
In broad terms, therefore, the bullish consensus outlook for the Japanese currency is predicated on three principal assumptions: that the yen is undervalued against the US dollar in terms of relative rates of inflation; that Japan's trade and current account surpluses will continue to expand; and that interest rate differentials in comparison to the US will tend to move in the yen's favour.

The first of these views is almost certainly true. As is shown in Chart 1, it is very likely that the yen is currently trading below its longer term sustainable level against the US dollar. However, any analysis which focuses solely on the yen/US dollar is apt to produce a narrow perception of the outlook for the Japanese currency. In this instance, moreover, we feel that the perception will prove biased. Although the yen weakened against the US dollar during 1981, it maintained or extended its gains against other major currencies.

Charts 4 and 5 illustrate the exchange rate values of the yen against the Deutschemark and Pound Sterling since 1973. It is evident that the yen has appreciated substantially against both currencies during the past two years. The yen's 20% rise against sterling since April 1980 'corrected' a situation where sterling had been significantly overvalued against the yen in terms of relative price competitiveness. However, over the past eight years inflation in West Germany has, on average, been lower than in Japan. Consumer price inflation has averaged a year-on-year rate of 4.8% in West Germany compared

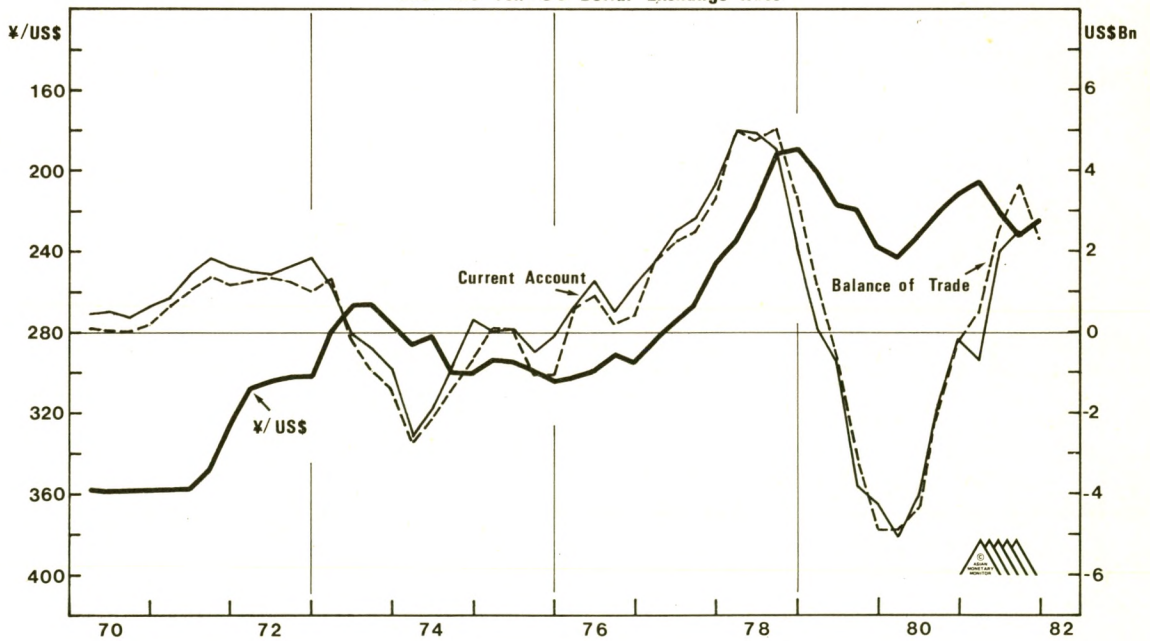
JAPAN

Chart 2: Purchasing Power Parity Indicators and the Actual Level of the Yen-US Dollar Exchange Rate



JAPAN

Chart 3: The Relationship Between Japan's Trade and Current Account Position and the Yen-US Dollar Exchange Rate



with 8.6% in Japan, and the average annual increase in unit export prices has been 4.4% in comparison to 4.8% in Japan. Thus the 30% appreciation of the yen against the Deutschmark since the end of 1979 implies that the Japanese currency is now significantly overvalued against the Deutschmark on Purchasing Power Parity considerations.

Charts 2, 4 and 5 illustrate two basic factors which should be considered in assessing the outlook for the yen. First they suggest that the yen is not undervalued, in terms of price competitiveness, against all currencies. Indeed, the yen is considerably overvalued against many of the European Monetary System currencies (including the Deutschmark, Dutch Guilder and Austrian Schilling) and the Swiss franc. Second, these charts illustrate that Purchasing Power Parity analysis only gives an indication of the long term trend for exchange rates: large cyclical deviations from the longer term trend frequently occur.

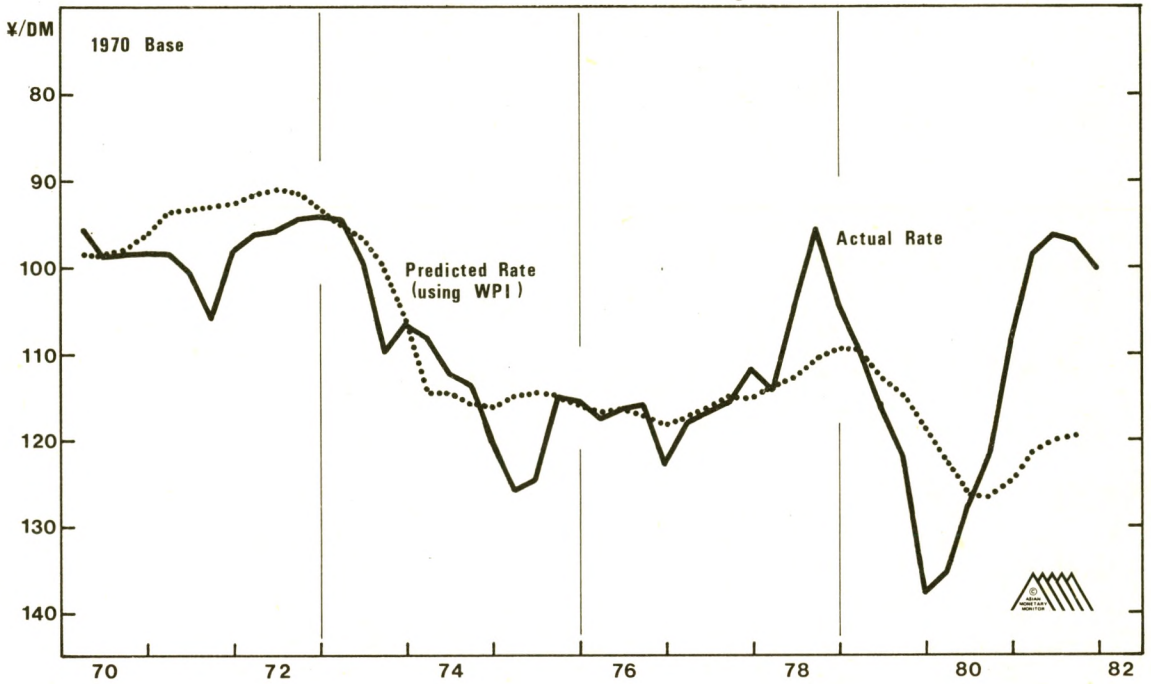
Let us briefly examine the transmission mechanism underlying Purchasing Power Parity theory. The idea behind Purchasing Power Parity analysis is simply that, with floating exchange rates and assuming all other things unchanged, adjustments to the exchange rate between two economies will be determined by changes in the relative price of goods and services traded between these countries. Thus if the prices of Japanese exports rise at a slower pace than the prices of exports from the US, but the yen/US dollar exchange rate remains unchanged, then consumers in both countries will increasingly purchase more of Japan's products and less of those from the US. Thus the economic mechanism whereby actual exchange rates tend towards the rate implied by relative price competitiveness is changes in the trade or current accounts of the countries concerned.

It should be clear, therefore, that the first two assumptions underlying bullish projections for the yen are merely opposite sides of the same coin. It would be more accurate to argue that: the yen is "undervalued" against the US dollar and will appreciate providing the trade and current account surpluses continue to improve. Thus, unless there is an improvement in the capital account of Japan's balance of payments - which is by no means certain to occur - the argument that the yen will appreciate towards the level implied by Purchasing Power Parity theory is conditional on a growing trade and current account surplus.

In our opinion, however, official and other forecasts for a continued rise in Japan's trade surplus during 1982 will be disappointed. Japan's trade surplus is either at or very close to a cyclical peak. Chart 6 indicates the underlying trend in Japan's trade account as described by the relative growth of exports and imports measured both in terms of US dollar values and in terms of volumes. Chart 6 reveals a deterioration in the growth of the value of exports relative to the value of imports during 1981. During the last quarter of 1980 and the first quarter of 1981 the value of Japan's exports rose an

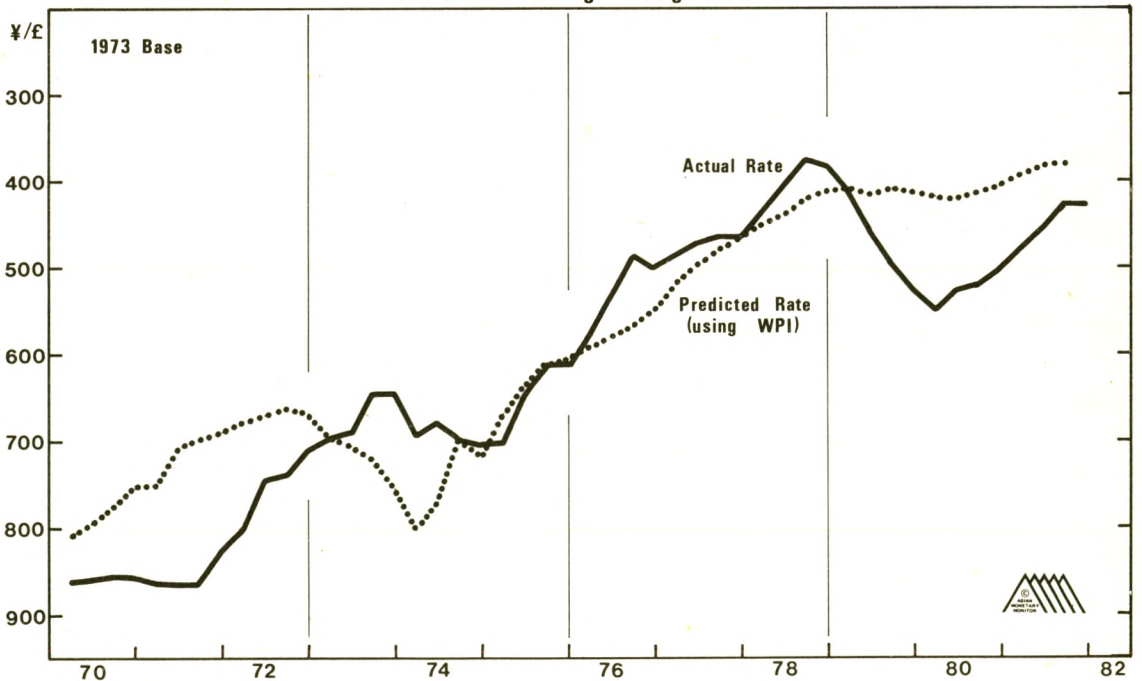
JAPAN

Chart 4 : A Purchasing Power Parity Indicator and the Actual Level of the Yen-Deutsche Mark Exchange Rate

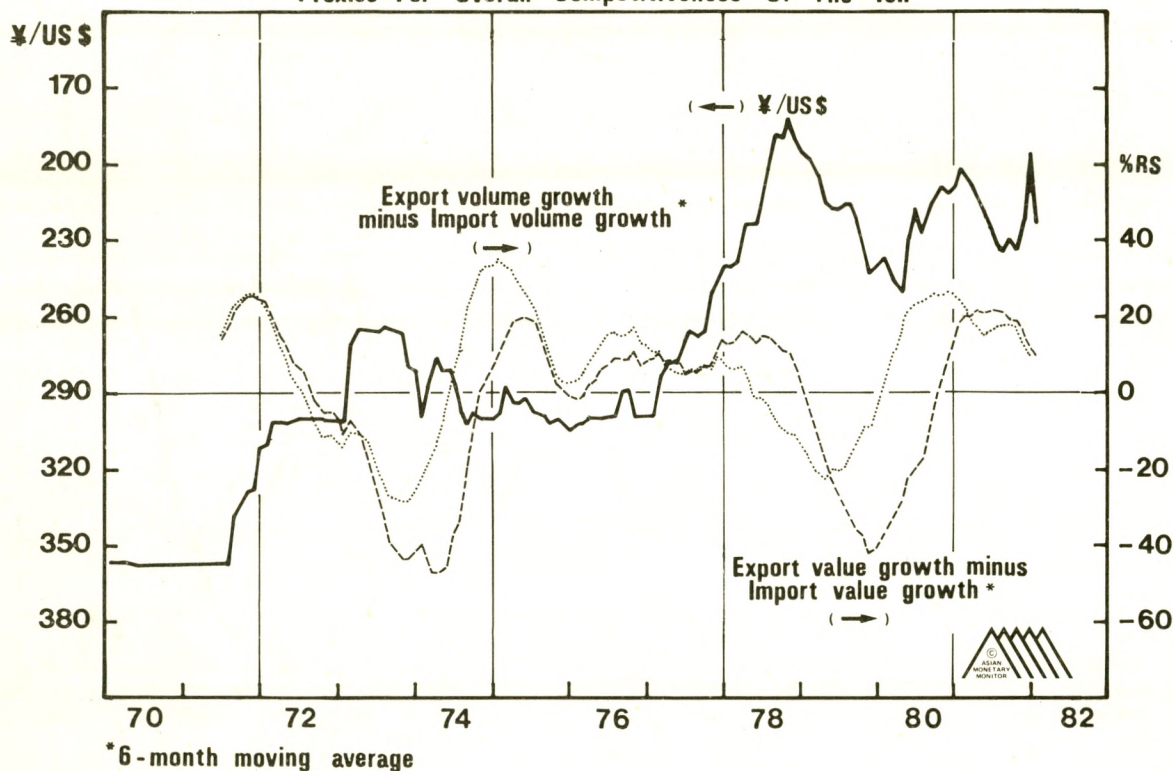


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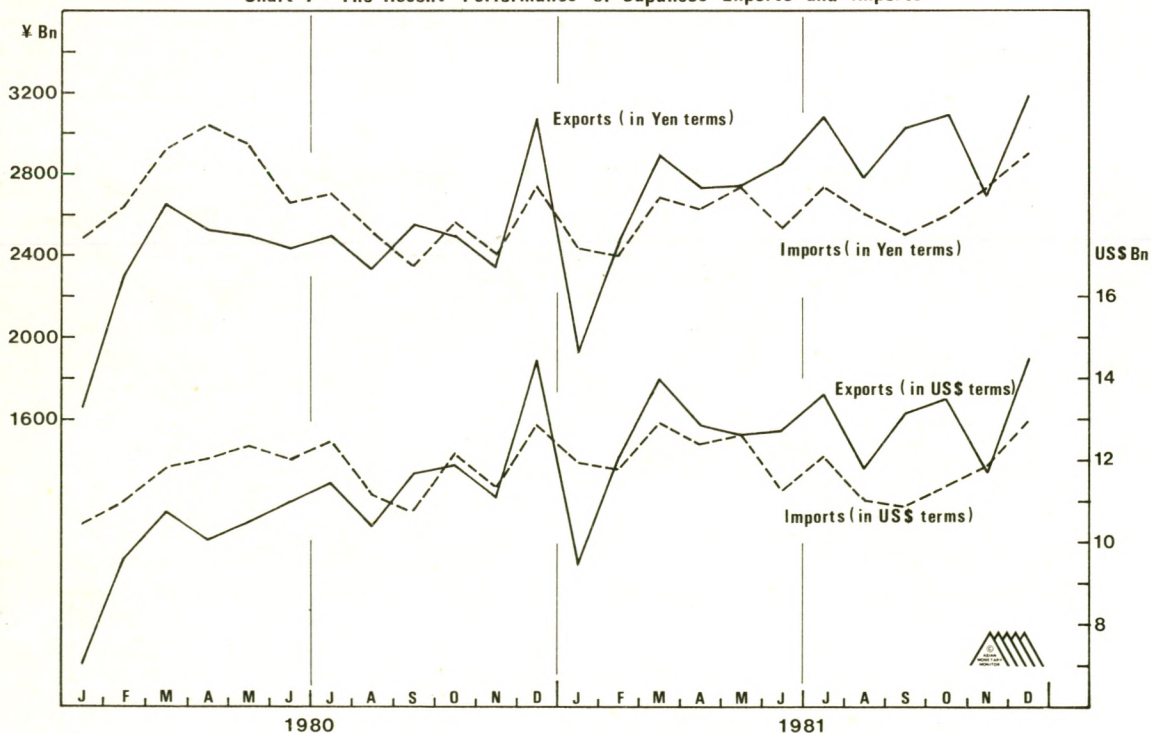
Chart 5 : A Purchasing Power Parity Indicator and the Actual Level of the Yen-Sterling Exchange Rate



Japan : Chart 6
Proxies For Overall Competitiveness Of The Yen



JAPAN
Chart 7 : The Recent Performance of Japanese Exports and Imports



average of 30% over the corresponding period of the previous year. The value of imports during that period was growing at an annual rate of only slightly more than 10%, and the combination of these trends produced a dramatic improvement in the Japanese trade balance. During the remainder of the year, however, growth in the value of Japan's exports declined substantially. In the fourth quarter of 1981, export values had grown only 7% over the previous year, and in December total export receipts were unchanged on a year-to-year comparison. In December Japan recorded the slowest growth in its exports since the end of 1975. Nevertheless, Japan's trade surplus continued to grow rapidly. The reason for this was that although export growth declined, Japan's demand for imports was also sharply curtailed by a slower level of economic activity in the domestic economy. The year-to-year increase in imports declined steadily into the summer of 1981 and registered an absolute decline during the third quarter before levelling off in the final three months in the year. Chart 7 records the monthly level of Japan's exports and imports since the beginning of 1980, measured in both US dollar and yen terms. This chart strongly suggests that the value of imports has reached a cyclical trough and export growth is declining, even when measured in yen terms.

Of course the most important question as far as the medium term prospects for the yen are concerned is how the trend in Japan's trade and current accounts will develop from here. At this juncture it is appropriate to note the divergence between the present conduct of monetary policy in Japan and elsewhere. The Bank of Japan is now one of the very few central banks that is following an expansionary monetary policy. Chart 8 displays recent trends in monetary growth in Japan, the US, the UK and West Germany, relative to the monetary targets established by their respective central banks. The outstanding feature of Chart 8 is that it shows the Bank of Japan was the only central bank deliberately attempting to stimulate domestic monetary growth during 1981. This feature was especially noticeable during the second half of the year, when the Bank of Japan forecast a year-to-year increase of 10½% in M2+CDs. The Bundesbank's monetary target allowed for slower growth in the wider monetary aggregates (M3 rose 5.4% during 1981) than in Japan, and the target was more restrictive than in 1980 where the Central Bank Money Stock was targeted to rise by between 5% and 8%. (The CBMS was targeted to increase between 4% and 7% during 1981, and the Bundesbank expressed its desire to see CBMS growth towards the lower end of the target band.) Although the monetary targets in the US and the UK allowed for growth in the wider aggregates to be at least comparable with that experienced in Japan (The Federal Reserve hoped that M2 growth would be limited to 9½% in the US, whilst the Bank of England stated that it intended to restrain £M3 growth to an annualised rate of between 6% and 10% between 1981 and April 1982) we can make a number of additional observations in comparing the restrictiveness of monetary policy in these three economies. In the US, for example, there is a demonstrably superior correlation between the level of economic activity and M1 than between economic activity and M2. Also M1

growth was sharply curtailed during the year which suggests an effectively restrictive Federal Reserve stance.

In the UK, too, there is good reason to believe that the year-to-year growth in £M3 has been an unreliable monetary indicator in recent years. During the period whilst the Bank of England operated the "corset" (from June 1978 to June 1980, the Bank of England imposed quantitative restrictions on the rate of growth of banks' eligible liabilities) it is likely that the £M3 statistics underestimated the growth of 'money' in the UK economy, since the "corset" imposed an artificial constraint on the rate of growth of banks' balance sheets. Conversely, after the "corset" was abolished it is very probable that the official £M3 estimates overstated liquidity growth in the UK. The sharp rise in the reported rate of growth in £M3 after July 1980 almost certainly reflects substantial reintermediation back into the banking system (and hence into the £M3 statistics), rather than an abrupt increase in overall money growth.*

A further observation to be made is that although actual monetary growth in Japan and the US was fairly similar, and although monetary growth in Japan was less than in the UK, changes in monetary policy in the US and the UK were towards monetary restraint, whereas the change in monetary policy in Japan was towards an easier stance. The changes in monetary policy in the US and the UK took two different forms. First, both countries' central banks reduced their monetary targets. Second, both central banks found difficulty in reaching these targets at the prevailing rates of interest. Initially, they had to adopt an even more stringent stance in an effort to reach their policy objectives, and ultimately in both the US and the UK interest rates rose during the second and third quarters of 1981. Both the US dollar and sterling strengthened against the yen as a result.

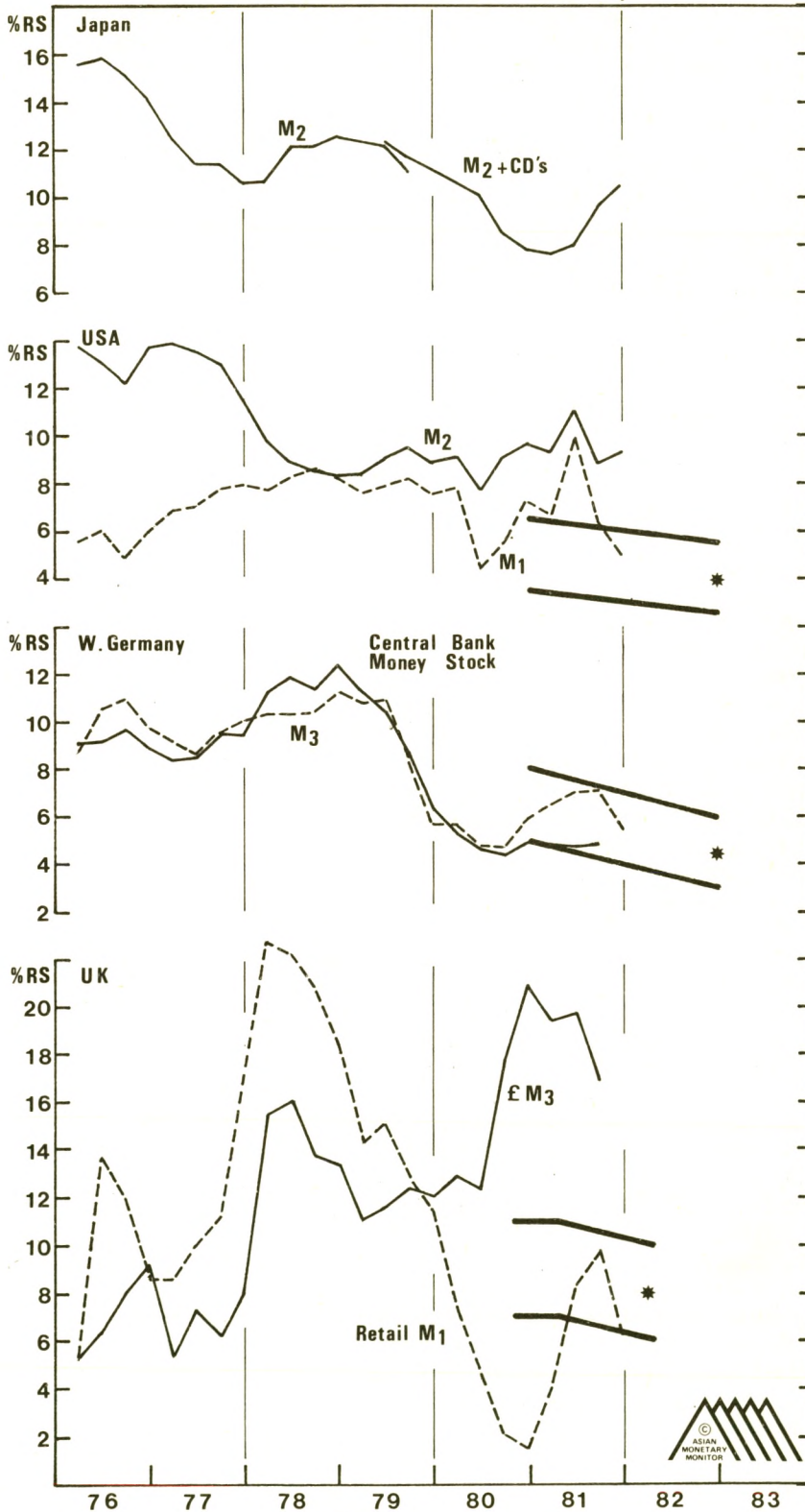
The divergence between monetary trends in Japan and elsewhere implies that the level of economic activity within Japan is likely to be higher than in other major economies. If this is so, it is very likely that a cyclical downturn in both Japan's balance of trade and current account will occur during 1982.

The consequences of the Bank of Japan's relaxed monetary policy on Japan's import demand during 1982 can be examined with the aid of Chart 9. The chart suggests that, on the evidence of previous business cycles, the combination of a rise in monetary growth and lower inflation will lead to a continuation of the recent cyclical upturn in industrial production. With the nominal value of industrial production also set to rise further, we may confidently expect this to produce an upturn in Japanese demand for foreign goods. We cannot, at this stage, predict the extent of this rise - this will depend on how long the Bank of Japan continues with its current relaxed monetary stance, and how long domestic inflation can remain at its present low level - but it is clear, at least, that Japanese import demand will recover from the depressed levels of last summer.

*Both the monetary base and M1 grew at a much slower pace in 1980 and 1981 than did £M3. The monetary base expanded by only 5% during 1980 and M1 grew by 11% in 1981.

JAPAN

Chart 8: International Trends in Monetary Growth



A further important factor suggesting that Japan's imports will rise during 1982 lies with the potential for an increase in Japanese real consumption expenditure. Although real GNP grew by a respectable 3.2% in the year to September 1981, this increase was concentrated in the external sector of the economy and real consumption expenditure has been virtually unchanged during the last eighteen months. This reflects the lagged impact of the Bank of Japan's restrictive monetary policy during 1980, and of relatively high levels of consumer price inflation up until the first quarter of 1981. However, in the same way that higher real monetary growth and lower inflation will stimulate domestic industrial activity, the stage is now set for a rise in real consumer spending: this will also tend to generate a higher level of imports.

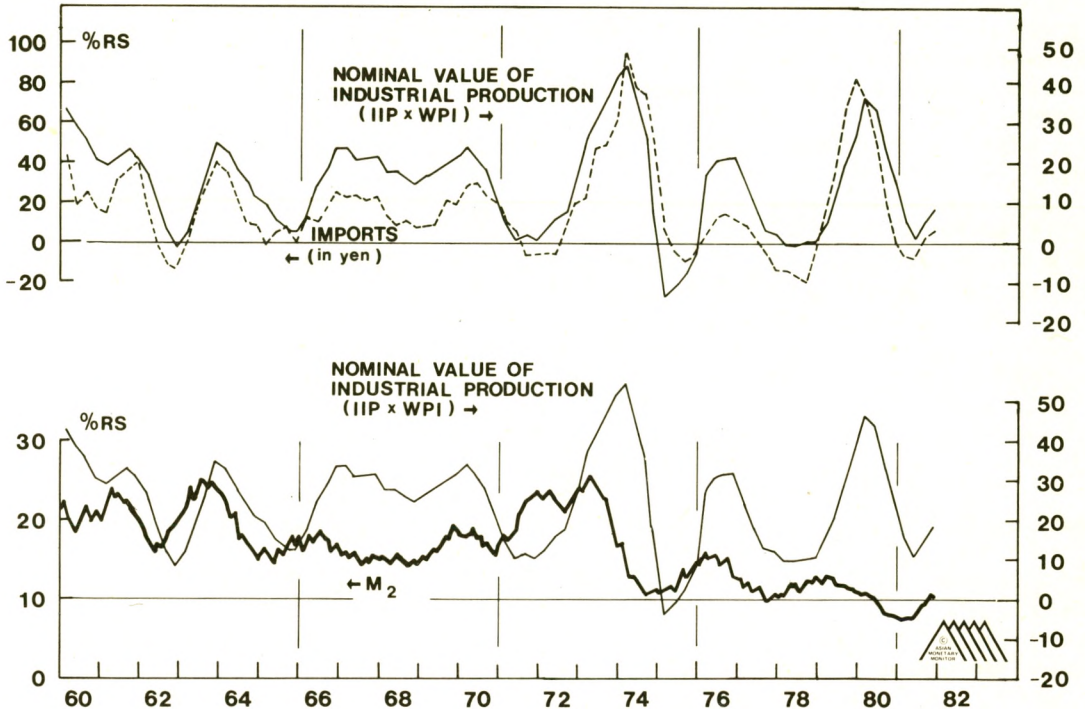
Turning to the export component of Japan's balance of trade, Chart 10 suggests that the downtrend in Japanese exports will be sustained throughout 1982.

Chart 10 needs to be interpreted with care. It is immediately obvious that the trend in Japanese exports growth is rather more difficult to explain and to predict than the trend in imports. In trying to assess the outlook for Japanese exports one is fundamentally concerned with foreign purchasing power, or the potential demand for Japanese goods. The lower segment of Chart 10 shows the yearly rate of change in the combined broad money aggregates of the US, the UK and West Germany, and the yearly aggregate growth in nominal GNP of these economies. It appears that, as in past business cycles, the changes in monetary and nominal income growth in these three countries can form a useful proxy for spending power in the world economy. Both series in the lower portion of the chart are measured in yen terms in order to attempt to demonstrate the generalised purchasing power potential for Japanese goods. It should therefore be apparent that, using this idea, an increase in the overall demand for Japanese exports can stem either from a rise in nominal and real income growth - and hence an acceleration in import demand - in importing economies, or from a depreciation in the yen against these countries' currencies.

The middle segment of Chart 10 shows the impact that changes in overall purchasing power in the US, the UK and West Germany have had on the rate of growth of their combined imports and on the trend in Japanese exports. Once again, the underlying data have been converted into yen terms. It is clear that there is a strong positive correlation between changes in the potential purchasing power for Japanese goods and the trend in total exports from Japan as measured in yen terms. (This suggests that it is legitimate to use nominal income growth in these three economies as an approximation for the overall potential demand for Japanese exports.) The problem, however, is how to interpret this strong correlation taking into account the underlying prospects for the yen. For example, both the trend in generalised purchasing power for Japanese exports and the trend in Japanese exports growth, as measured in yen terms, appeared bearish for the yen at the

JAPAN

CHART 9 : DETERMINANTS OF IMPORTS



start of 1977. Yet the yen was to appreciate against nearly all currencies during the following eighteen months, and export volumes continued to rise from the high levels achieved in 1976 at a modest, though respectable, rate of 7%. Similarly the favourable upturn in world purchasing power and export growth which was achieved in the first half of 1979 also proved a misleading indicator for the prospective strength of the yen which experienced cyclical weakness throughout the year during a period when export volumes registered a substantial decline.

In trying to interpret Chart 10, there are two factors to be aware of: first, the impact of "valuation" changes (i.e. changes in the yen exchange rates) on combined rates of monetary growth, combined rates of nominal income growth, and Japanese export growth, all of which are measured in yen terms, in the same direction. This in itself accentuates the strong positive correlation depicted in Chart 10. Second, and more importantly, Chart 10 highlights a problem which will be familiar to all investment managers involved in the Japanese stock market: will a weaker yen (usually characterised by an upturn in the series in the bottom segment of Chart 10) promote stronger export growth, or is weakness in the yen a result of slower export growth? There is no clear cut answer to this question; the good correlation between the series in the bottom two segments of Chart 10 simply shows that both effects are important and that causality (a "lower" yen promoting "stronger" exports, and "weaker" exports generating a "softer" yen) runs both ways. One way to disentangle these effects is to look at the growth of export volumes. If one examines the trend in

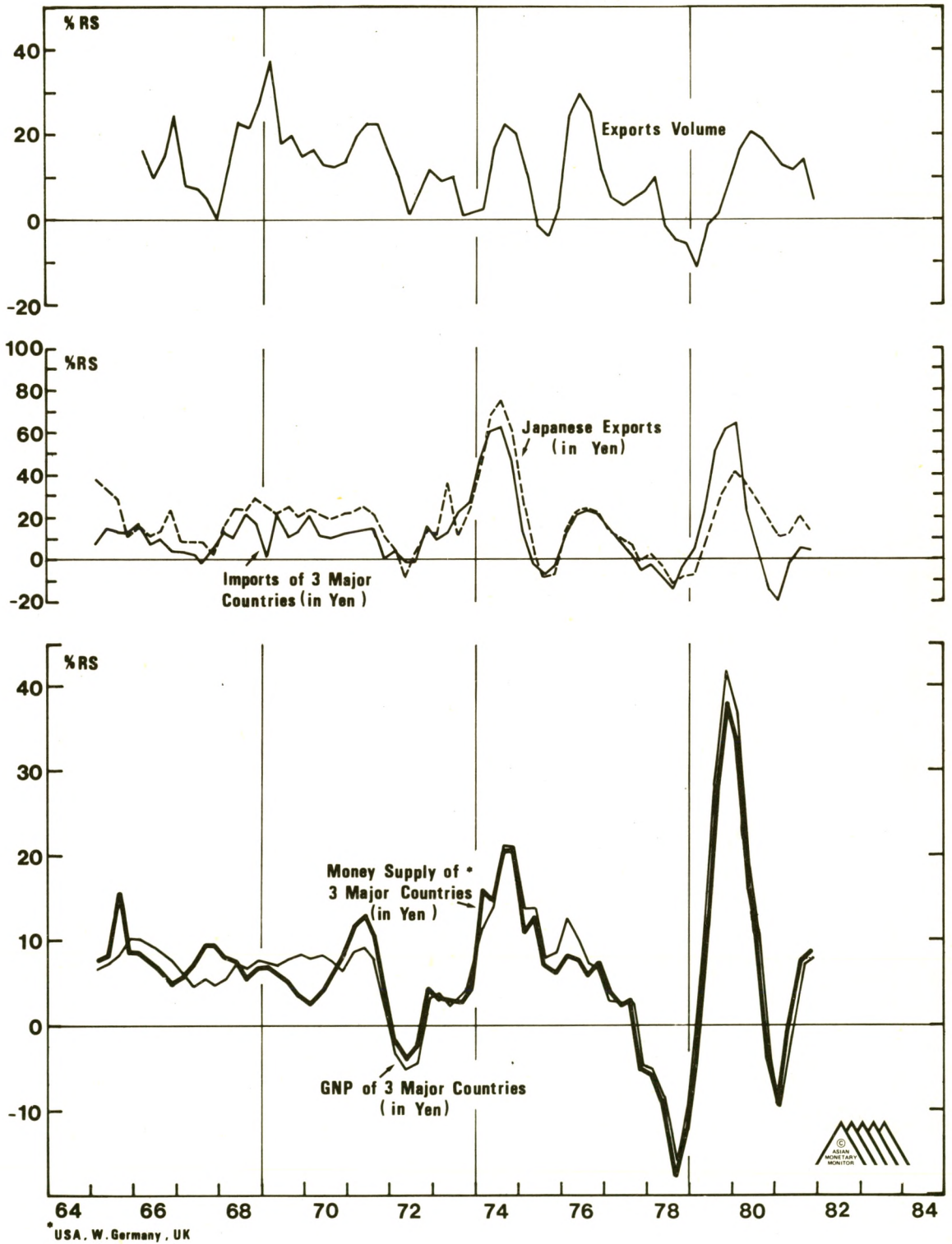
export volume growth during the period since the Bank of Japan allowed the yen to float freely on the foreign exchanges it is clear that there is typically a lag of up to four quarters between a reversal in the trend of potential purchasing power for Japanese exports and a reversal in the trend in export volume growth. For example, Japanese exports, measured in volume terms, fell during the second quarter of 1978, and this helped to precipitate a weaker yen in the final quarter of that year. Nevertheless, in spite of the combined impact of a weaker yen, and relatively strong nominal income growth in Japan's export markets, it was not until the third quarter of 1979 that the volume of exports showed any signs of recovering. Similarly the impact of a stronger yen and the economic slowdown in most O.E.C.D. economies during 1980 did not produce any significant downturn in the growth of Japan's export volumes until the end of 1981.

As can be seen in Chart 10, the potential demand for Japan's exports has recovered somewhat from its depressed levels at the start of 1981. The combined imports of the three countries representing Japan's export markets have also recovered slightly, and this has enabled the growth in yen export receipts to level off in the last part of 1981. However, the growth of Japanese export volumes has declined quite sharply during this period. This leads to the inference that the weaker yen is partly a consequence of falling Japanese exports, and that the yen weakness has not, in spite of continued growth in yen export receipts, rekindled the demand for Japanese goods. The outlook for 1982, therefore, does not look too promising so far as Japanese exports are concerned. The sharp recession which emerged in the US economy during the fourth quarter of 1981 is already reflected in both the potential demand for Japanese output, and in slower import demand. With the Federal Reserve pursuing a more restrictive monetary policy in 1982 than in 1981, US nominal income growth will likely prove lower this year than last, providing additional constraints on the ability of Japanese companies to sell successfully in overseas markets. Until there are signs of a recovery in volumes one should be cautious for the prospects of Japan's export sector.

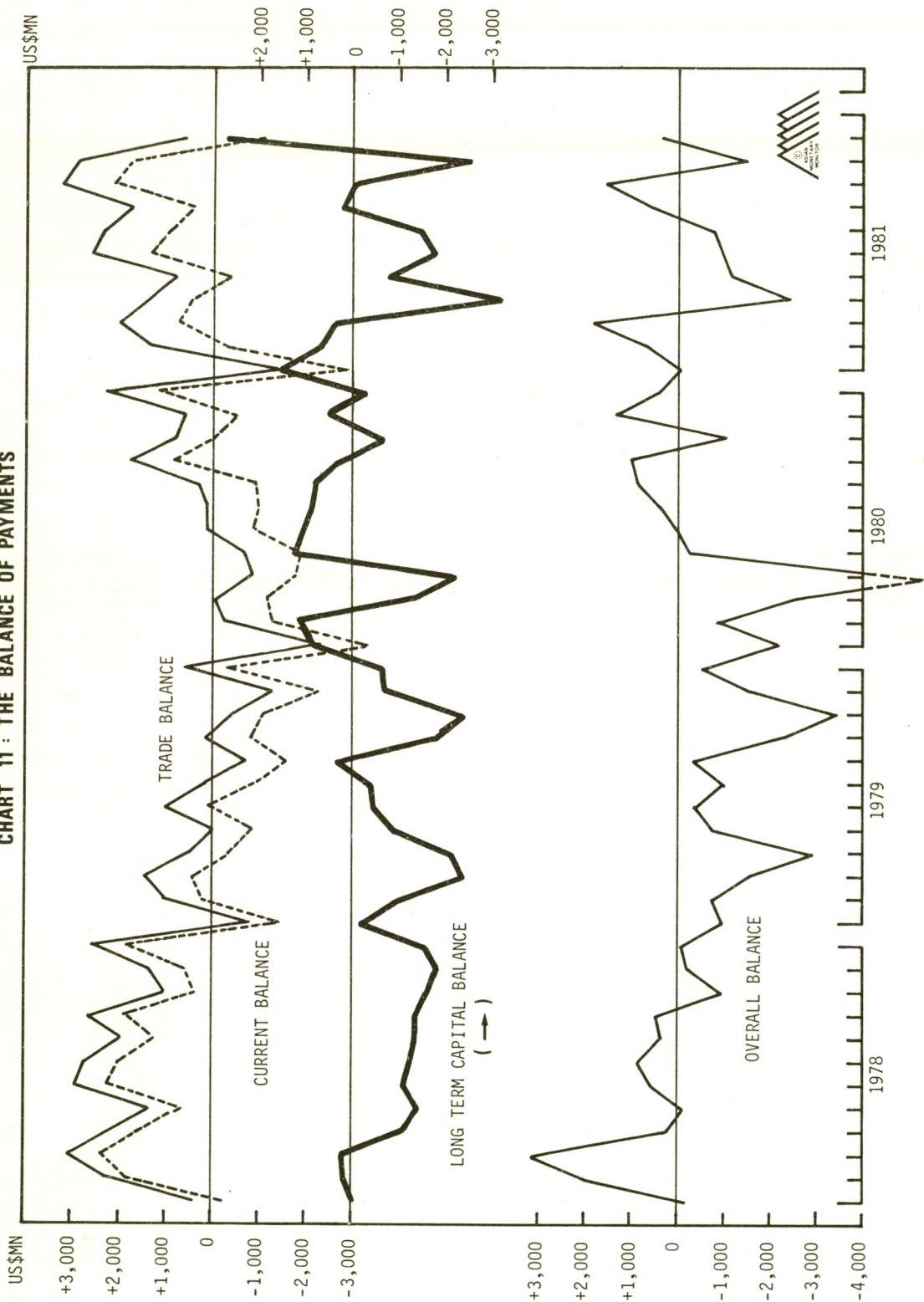
FORECAST: The combination of fundamental economic circumstances analysed above does not support the optimistic prospects which have been argued for the yen. Japanese exports have already peaked, and import demand will accelerate in response both to continued growth in the level of industrial production and the likelihood of a recovery in consumer spending. Taking both components of the trade account into consideration, therefore, it is very likely that the surplus on Japan's trade and current accounts reached a cyclical peak during the final quarter of 1981. In our opinion this peak basically reflects the divergence between monetary policy in Japan and monetary policy in other O.E.C.D. economies. The Bank of Japan's relatively easy monetary policy will produce a recovery within the domestic economy ahead of that to be expected in European countries and in the US. Japanese import growth is therefore likely to rise

JAPAN

Chart 10 : Determinants of Exports



JAPAN
CHART 11 : THE BALANCE OF PAYMENTS



faster relative to its exports than in other countries. By the same token, restrictive monetary policies in the US and most European countries can be expected to continue to reduce foreign demand for Japan's exports. This effect will be enhanced by the fact that the yen is 'overvalued' on a Purchasing Power Parity basis against the majority of E.M.S. currencies. It is also well worth noting that the only major currency against which the yen is significantly 'undervalued' (again, on a Purchasing Power Parity basis) is the US dollar where the Federal Reserve is trying to conduct a highly restrictive monetary policy and where, as a result, the US economy will experience quite prolonged weakness.

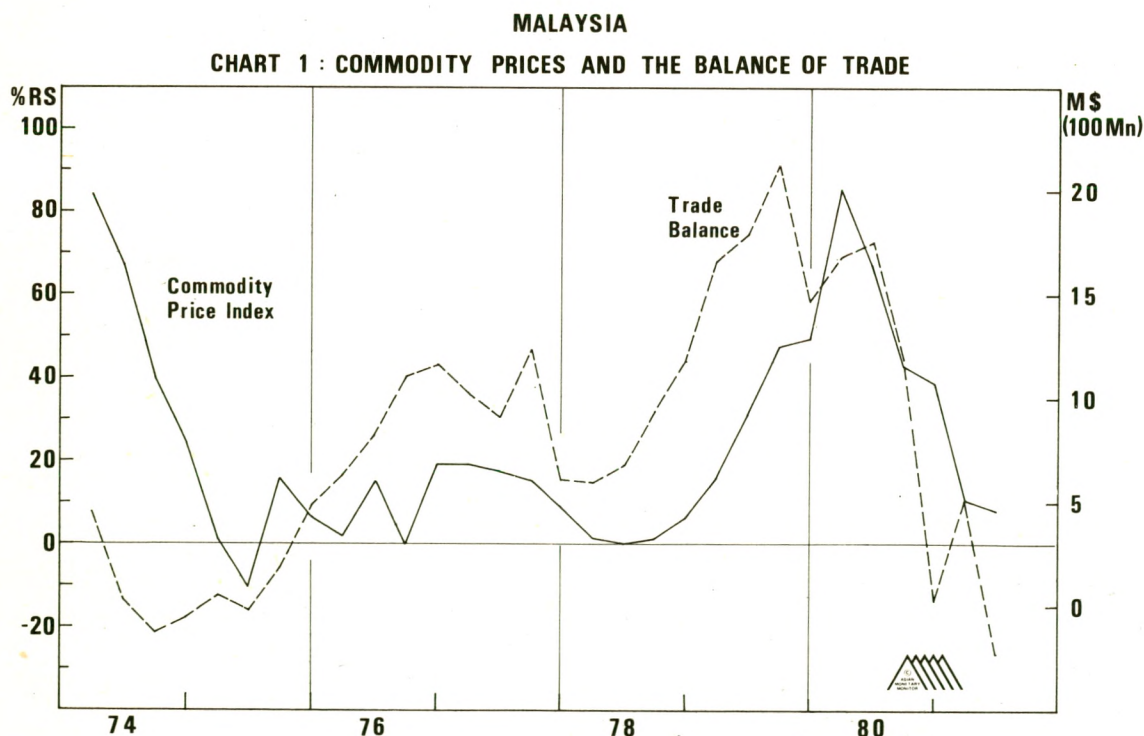
The combination of relatively easy monetary policy, a likely downturn in the current account, and continued deficits on the long term capital account will form the basis for cyclical weakness in the yen. Consequently the yen has probably already reached its cyclical high against most of the E.M.S. currencies (the French and Belgian francs may prove to be an exception to the general trend) which are now typically experiencing a cyclical upturn in their trade and current accounts. The same basic conclusion applies to the yen/US dollar rate. In the absence of declining short term interest rates in the US, the set of influences outlined above will produce a weaker yen. Although the economic fundamentals backing the yen are still, as yet, sufficiently strong to produce an appreciation in the yen as and when US interest rates decline, this show of strength will prove temporary, and it is doubtful whether the yen will achieve its estimated Purchasing Power Parity level against the US dollar in this business cycle.

MALAYSIA

DECLINING COMMODITY PRICES AND FISCAL EXPANSIONISM SPELL POORER PROSPECTS

Over the five years 1976-1980, the Malaysian economy enjoyed a period characterised by a high rate of economic growth, a strong balance of payments, and inflation in the low single digit range. The fine list of credentials generated by the Malaysian economy during 1979 and 1980 was catalogued in a previous AMM (Vol. 5 No. 4) where it was also suggested that the Malaysian economy faced a severe cyclical downturn. This downturn has now begun and the indications are that the Malaysian economy is now in the middle of a prolonged period of deterioration. This article identifies the factors which were working in Malaysia's favour over the latter half of the last decade and contrasts these with conditions prevailing at the moment and in the likely future.

Trends in the Malaysian economy are heavily influenced by trends in the external account and the most important factor for the Malaysian economy of 1976-1980 was the healthy trade surpluses experienced over this period. Roughly three quarters of Malaysia's exports comprise six commodities - rubber, tin, sawn logs, timber, palm oil and petroleum and therefore obviously the trend in the prices of these commodities on world markets is of crucial importance for Malaysia's economy. This is illustrated in Chart 1 which shows the relationship between



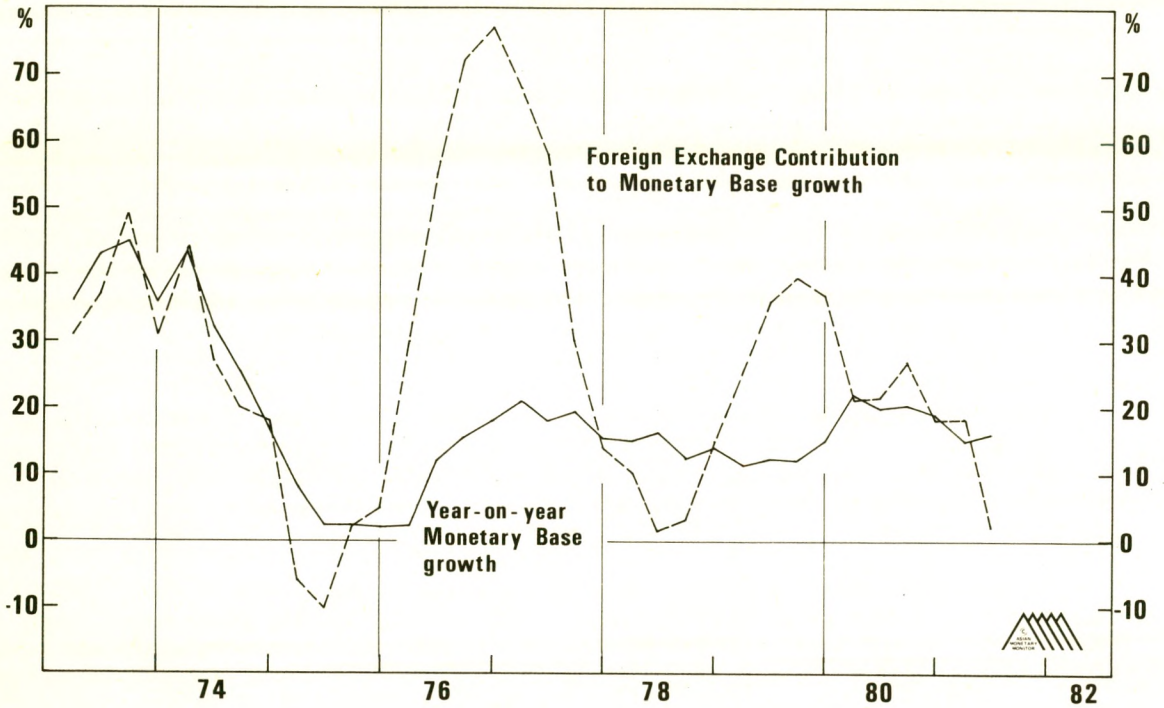
the balance of trade and the rate of increase of a trade-weighted index of these commodities' prices. The index is similar to a revenue index so that strength in the index could be explained by either a generalised firmness in commodity prices or by a proportionate increase in the export of a commodity whose price is rising faster than average commodity prices. Thus, strength in the trade-weighted commodity price index over the latter half of the 1970's can then be easily explained by the fact that whereas petroleum comprised only 9% of total exports in 1975, the proportion had risen to 24% by 1980. Even if there was scope for a continued rapid growth of oil production - and Malaysia's known reserves are fairly limited, amounting to 2.5 bn. barrels compared to annual production of over 100 m. barrels in 1980 - price trends for at least the next year are likely to prove unfavourable. As it is, the state-owned oil company, Petronas, has cut production, and Malaysian crude oil prices have recently been cut by up to \$1 per barrel. Thus, oil is unlikely to contribute any upward movement in the commodity price index, and therefore the balance of trade, over the coming year or so.

Trends in the balance of payments have had important implications for monetary growth. Chart 2 illustrates that the rapid growth of the monetary base, and hence money supply, in 1973 can be explained entirely by the growth in net foreign assets held by the central bank - the result of the large balance of payments surplus in that year. This explosion in monetary growth was followed by an equally rapid explosion in inflation in 1974. However, it can also be seen that after 1975, large increases in net foreign assets held by the central bank were not reflected so markedly in increases in the size of the monetary base. This roughly corresponds with the period in which Bank Negara Malaysia (BNM) began to pay increased attention to the growth of the monetary aggregates.

Due to the relatively small size of the BNM's holdings of Federal Government securities, in the past monetary policy has been largely conducted either by the alteration of statutory reserve requirements (which would have tended to distort the statistical relationship between the monetary base and monetary aggregates) or via the impact of the government's fiscal operations. An examination of BNM's balance sheet reveals clearly that by far the most important factor offsetting the stimulus to monetary growth provided by external surpluses has been the build-up of government deposits at the central bank. Chart 3 illustrates the relationship between the growth of outstanding government debt and the contribution of increases in net foreign assets to the growth of the monetary base. This illustrates that government over-funding of its budget deficit has in the past acted as an important offset to monetary growth in times of large balance of payments surpluses - resulting in a transfer of commercial banks' reserves at the central bank to government deposits.

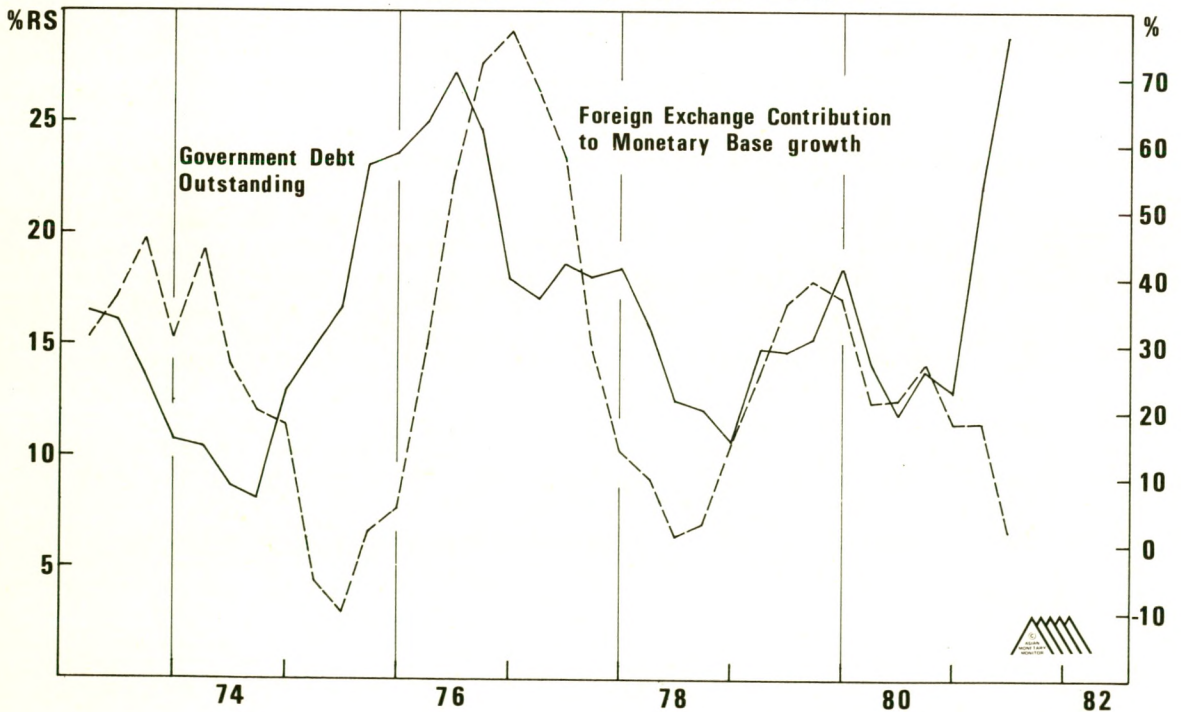
MALAYSIA

CHART 2: THE MONETARY BASE



MALAYSIA

CHART 3: THE NATIONAL DEBT AND THE BALANCE OF PAYMENTS COMPONENT OF THE MONETARY BASE



Briefly, we can say that from 1976-1979 there existed a situation in which Malaysian growth was powered by the external account while any undesired ill-effects for monetary growth, via increased foreign exchange earnings, that this might have had were offset by government fiscal and financial conservatism and the BNM's monetary conservatism.

Nevertheless, large balance of payments surpluses in 1976 and 1979 were still accompanied by substantial increases in monetary growth. This was partly BNM policy:- the BNM relaxed monetary restraint in these years of increased economic activity to prevent upward pressure on interest rates. It appeared to have no damaging effects, as despite the fact that M2 growth reached 28% at the end of 1976, inflation rose only to 5%-6% in 1978.

This low level of inflation is partially explained by the fairly rapid appreciation of the exchange rate over the period. There is strong evidence to suggest that, after a fairly steep depreciation of the Ringgit vis-a-vis the dollar in the latter half of 1975, the Ringgit was being managed at a substantially undervalued rate. This is substantiated by a study of the components of balance of payments deficit financing and the balance sheet of the BNM, which suggest that, if anything, BNM were buying foreign currency over and above the amount resulting from the balance of payments surplus and forcing the exchange rate down at the beginning of 1976. This paved the way for a steep appreciation of the Ringgit from 1976-1978, which, through its effect on import prices would have had favourable effects for inflation.

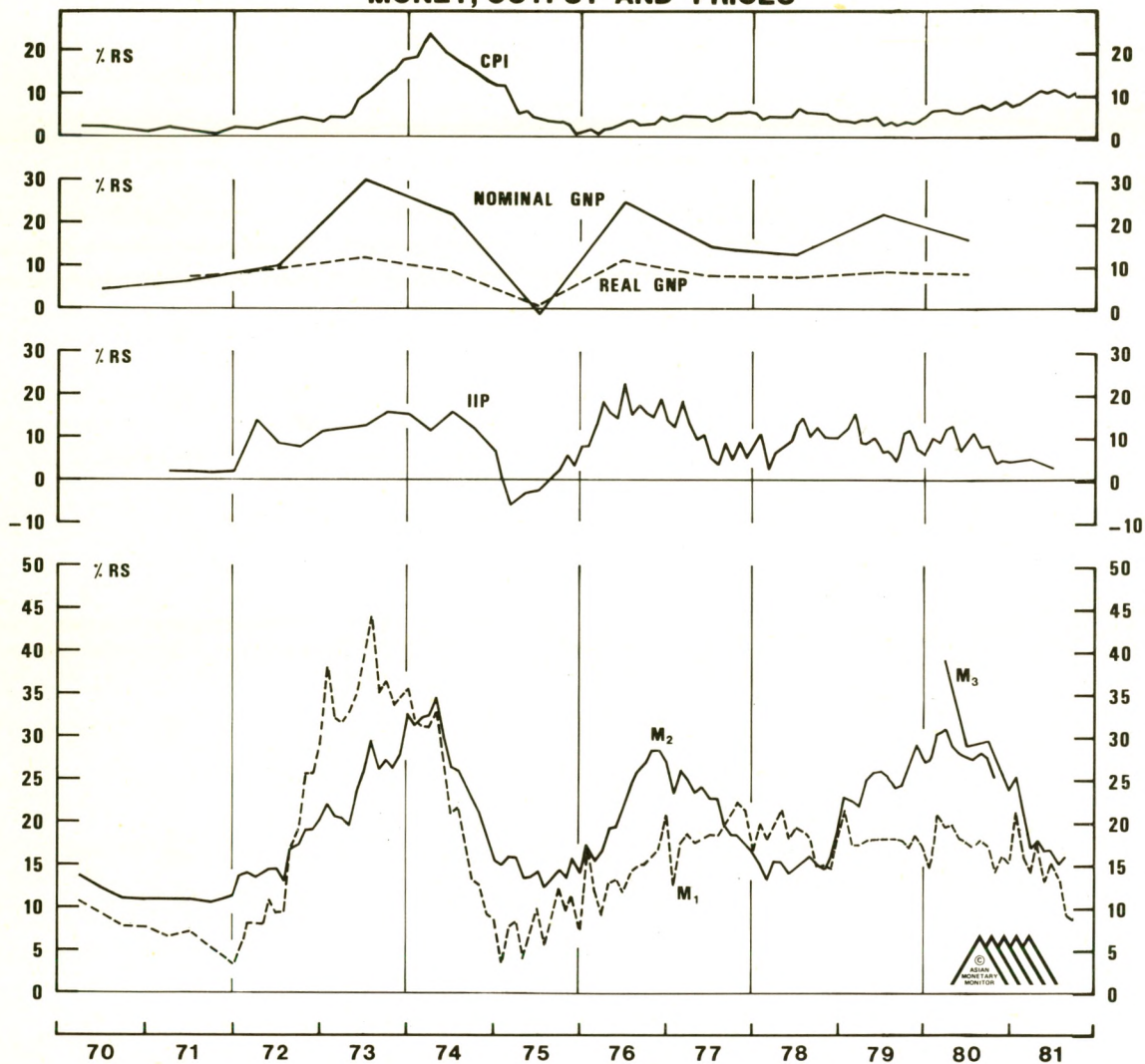
Since the middle of 1980 all this has changed. With stagnant or declining commodity prices the current account of the balance of payments has moved from surplus into substantial deficit. There are no signs of recovery in the near future and thus this trend should continue at least throughout 1982. M3 growth has slowed from over 30% year-on-year at the beginning of 1980 to around 15%, and M1 growth is now in single figures. After the rapid expansion of monetary growth and the upswing in the economy in 1979 and early 1980, inflation peaked at around 11% in the middle of 1981 - moderate by international standards but high by Malaysian historical standards.

Perhaps more importantly the government's policy stance has changed from one of fiscal conservatism to fiscal expansionism. The authorities are deliberately pursuing a counter-cyclical policy to increase government expenditure in an attempt to stimulate private investment and the growth of the domestic economy. The budget deficit for 1981 is estimated to have been M\$8.15 bn., and the target deficit for 1982 is M\$10.1 bn., or around 16% of GNP. This compares with deficits constituting about 8% of GNP in the latter half of the 1970's. The deficits are entirely the result of vastly increased development expenditure, this year focusing particularly on sustaining economic growth. However, given the concern of the BNM and the government with inflation, the worry is how these deficits will be financed.

MALAYSIA

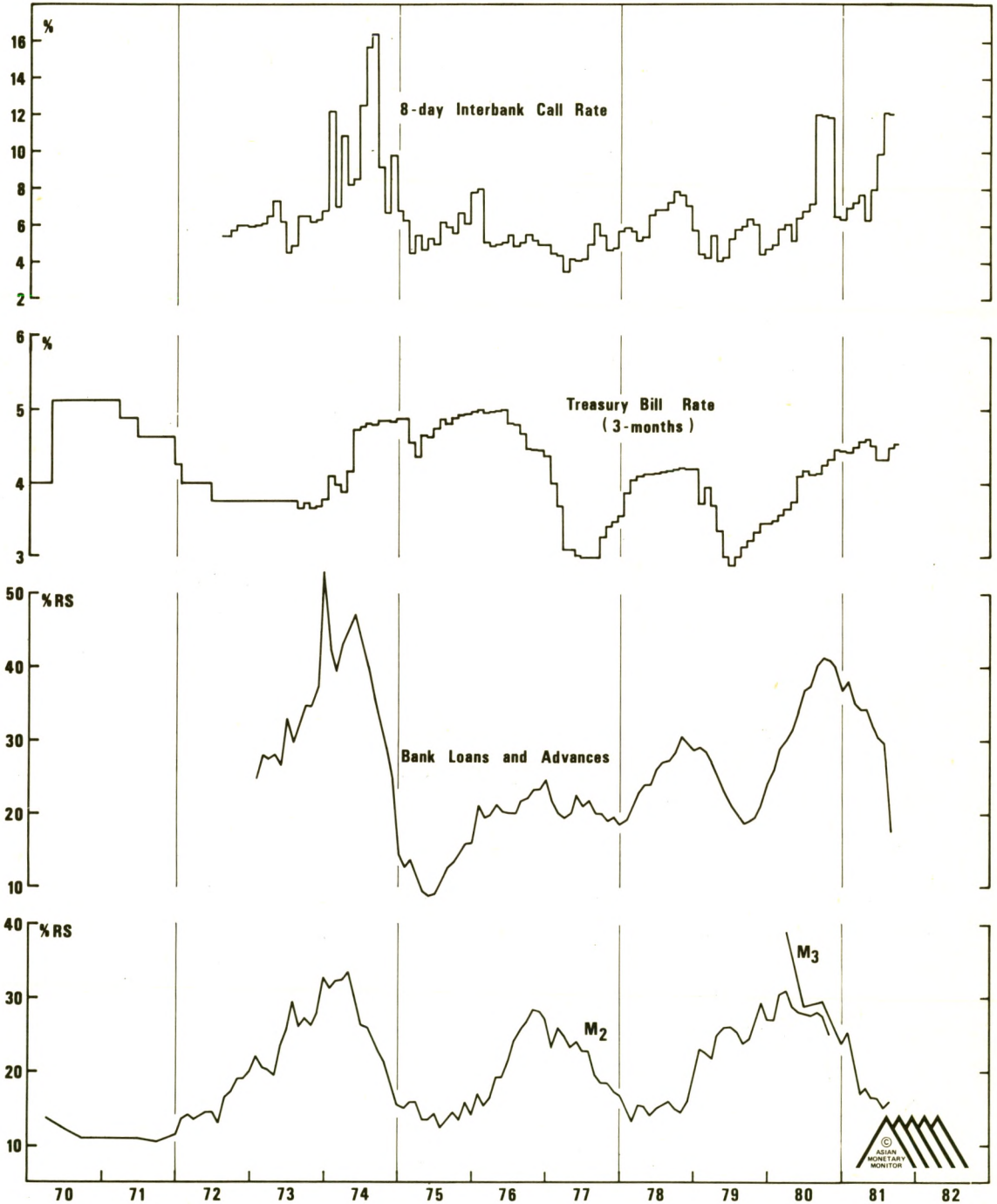
CHART 4

MONEY, OUTPUT AND PRICES

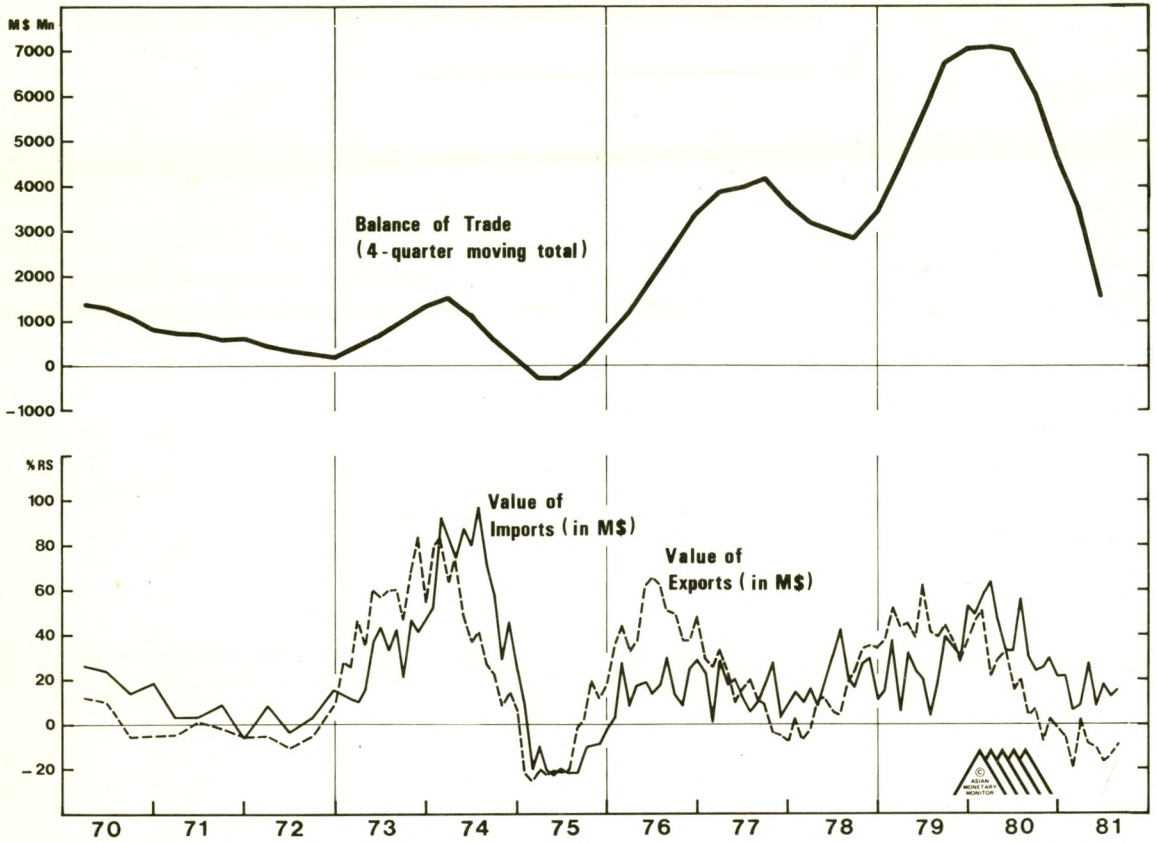


Malaysia

Chart 5
Monetary Growth, Loan Growth and Interest Rates



Malaysia
Chart 6: The Trade Account



Inflation in 1981 reached post-1974 highs and the BNM would be unwilling to see rapidly increased monetary growth. If we consider a few very rough numbers as an illustration, with growth likely to be around 5% in 1982 and inflation 8%-9%. a 14% growth of the monetary base might be considered compatible with the BNM's desire to keep future inflation under control. This effectively means that the monetary base can be allowed to grow by roughly M\$1 bn.

In the past Malaysian borrowing abroad to finance budget deficits has been negligible. However, this changed in 1981 when the government borrowed M\$2.9 bn. abroad to support the growing budget deficits. This has important effects for the balance of payments as such borrowing makes a substantial contribution to long-term capital inflows. The current account deficit for 1982 is projected at M\$6.48 bn. We believe this estimate is optimistic, based as it is upon assumptions of some recovery in commodity prices, but taking this figure as a guide, with private capital inflows the authorities may be left with a balance of payments deficit of around M\$3.5 bn. to finance. Moreover the government will tend to be doubly constrained in their borrowing abroad to finance budget deficits - partly by historical factors, and partly by the fact that heavy borrowing abroad will tend to put the overall balance of payments into surplus and thus cause the exchange value of the Ringgit to become increasingly unrealistic relative to the current account position.

Thus the government is likely to be left with at least M\$6.6 bn. of the budget deficit to be financed from domestic sources. If the government does not draw down any of its realisable assets, then M\$3.8 bn. bond sales to the central bank and M\$2.8 bn. to the non-bank private sector would give the required M\$1 bn. growth of the monetary base. However, roughly M\$3 bn. bond sales to the private sector would suggest a substantial clash with private sector credit demands.

Although the savings ratio in Malaysia is very high - gross national savings account for around 30% of national income - the trend over the last few years has been for private gross capital formation - or private sector investment - to grow faster than savings such that in 1980 savings produced only a M\$4.4 bn. surplus over private investment and probably produced no surplus in 1981. Thus the bond sales suggested above would comprise a very high proportion of private sector net financial asset acquisition, suggesting high interest rates. Most government bonds are bought by the Employees' Provident Fund which operates a forced savings scheme. However, increasing contributions to this scheme may not increase total savings but rather divert savings from private sector needs and hence not contribute to easier liquidity.

FORECAST: The government will probably help to avoid all these problems, as they did in 1980 and 1981, by financing the budget deficit by drawing on their realisable assets or Trust Fund balances. However, this cannot go on for ever and unless there is a turnaround in the downtrend in commodity prices sometime in the not too distant future, the prospects for the Malaysian economy will begin to look increasingly poor. As it is, it looks likely that liquidity will tend to become fairly tight in 1982 as the authorities pursue an easy fiscal/tight monetary policy mix. The exchange value of the Ringgit is likely to depreciate slowly but not by enough to correct the growing imbalance in the current account of the balance of payments. The currency will be supported by foreign exchange inflows arising from the government's borrowing abroad. This support of the currency above its 'equilibrium' level will only help to encourage a high rate of import growth and add to the current account deterioration.

SOUTH KOREA

A MONETARIST EXPERIMENT IN PROGRESS

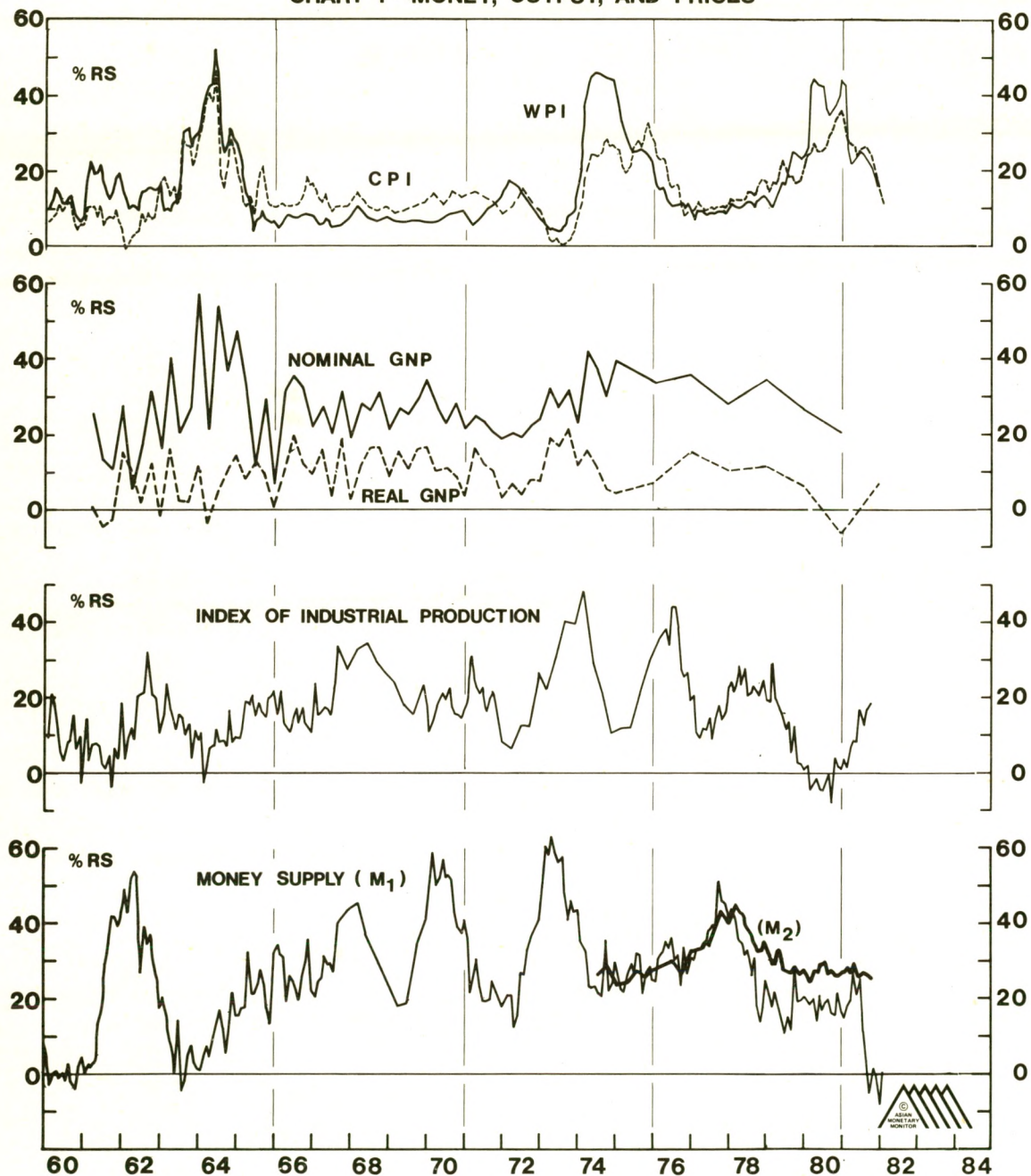
Following the decision of the Korean authorities in mid-1980 to abandon a rigidly pegged Won/US\$ exchange rate there are beginning to be some signs that the overall performance of the economy has notably improved: monetary growth is more stable, production is up, and inflation is down. Moreover, with the accession to power of a new administration in January 1982, further improvements could well be in the pipeline.

Until 1980 the pattern of economic behaviour in South Korea was dictated largely by the rigidly fixed but frequently altered exchange rate. Typically the authorities were ready at any time to devalue the currency, stimulating an export-led boom. Because there were extensive capital controls and therefore no possibility of a capital outflow to offset the inflows on capital account, the export boom would lead to strong domestic credit growth and an increase in borrowing from overseas. This process invariably led to a balance of payments surplus and an acceleration in monetary growth. Controls on imports prevented foreign goods from competing with domestic goods or from growing as fast as exports during the upswing, so the main consequence of the rapid money growth was a high rate of domestic inflation. But gradually inflation eroded export competitiveness, slowing export growth until another devaluation became necessary, whereupon the whole cycle was repeated. Like Brazil, South Korea chose to devalue frequently to maintain momentum in the economy, placing a higher priority on growth than on price stability.

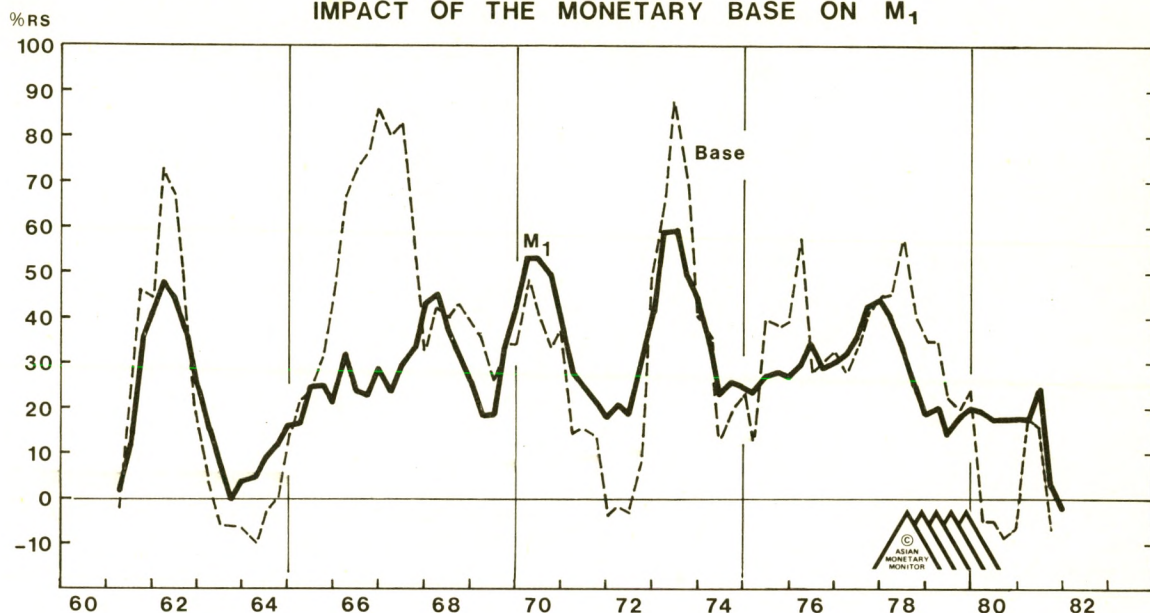
A brief period when Korea departed from this pattern was in 1971-73 when there were a series of both devaluations and upward revaluations, reflecting in large measure the experimental adjustments in exchange rates which were going on in most economies at that time. The net effects of these frequent small adjustments up and down cannot be clearly separated out and it is perhaps best to treat this period as a continuation of the fixed rate era.

However, starting in June 1980 there was a radical new departure in exchange rate policy. Since that time the exchange rate has been adjusted - generally downwards - on a fairly continuous basis by the Bank of Korea. The immediately obvious consequence is that monetary growth has become much more stable. Whereas in 1970, 1973 and again in 1977-78 there was a monetary explosion based on an export-boom, since 1980 exports have recovered dramatically from the slowdown of 1979, but monetary growth as measured by M2 has been held to a relatively steady growth path at just over 25% p.a. For the first time in their history the Korean authorities appear to be successfully controlling the money supply.

SOUTH KOREA
CHART 1 : MONEY, OUTPUT, AND PRICES



KOREA : CHART 2
IMPACT OF THE MONETARY BASE ON M₁



M1 grew at a slightly lower rate averaging exactly 21.0% in the period January 1980-June 1981. Since the introduction of a new savings deposit scheme in July 1981 there have been large transfers out of demand deposits to installment savings deposits and this has been reflected in a sharp downturn in measured M1. However, as the installment savings deposits are included in M2 it is safer to follow this broader measure of monetary growth for clues to the future behaviour of output and inflation.

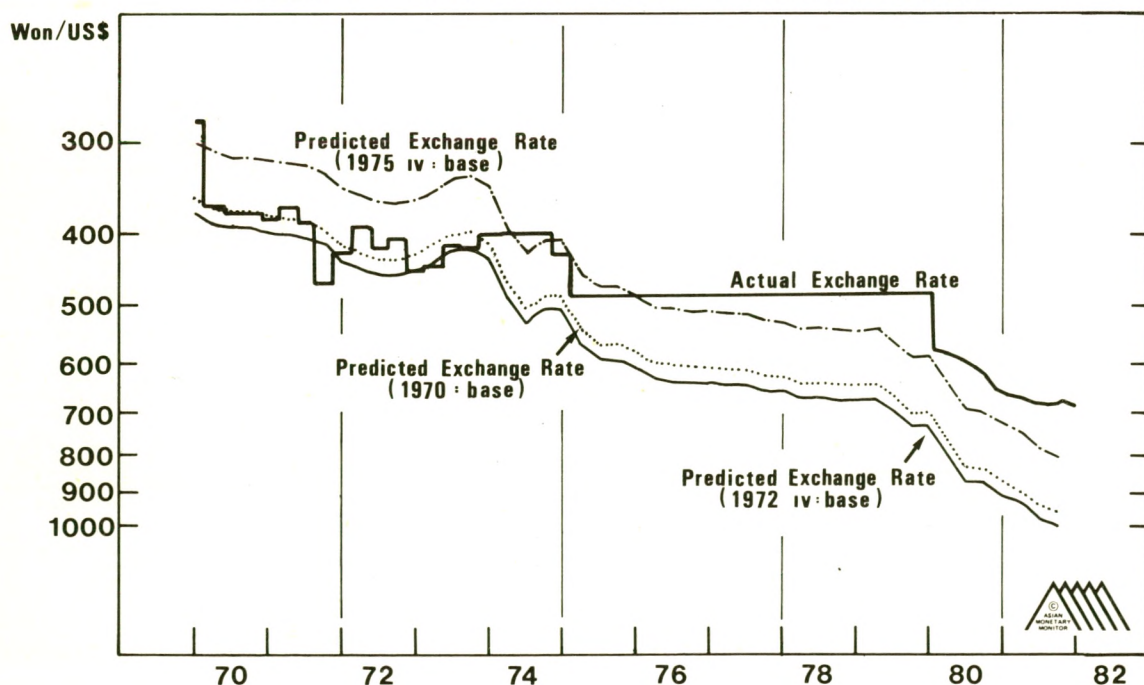
In calendar year 1980 the authorities set a target for M2 growth of 20% but at that time it would seem that they were unwilling to discipline the economy too severely. The 20% target would have meant halving monetary growth after growth rates of over 40% (at their peak) for M1 and M2 in 1977-78. Accordingly in June 1980 the M2 target was raised to 25%. But even this was overshot: in the year to December 1980 M2 grew by 26.9%. For the next year, 1981, the 25% target was retained, and this time the authorities came very close to hitting it: in December 1981 M2 growth registered 25.8%.

Now that the authorities are gaining experience with managing the exchange rate there is reason to think that they should be much more successful in hitting their monetary targets. Provided they allow the exchange rate to adjust to monetary growth rather than the reverse there is no reason why the Bank of Korea should not be as successful as the Bank of Japan in achieving its monetary targets. As yet it may be

premature to speculate as to which aspect of monetary policy - an exchange rate target, interest rate targets, or a monetary growth target - is receiving priority, but it would seem on the basis of recent evidence that the money supply growth target is gaining precedence. First, for calendar 1982 the authorities have announced a money supply growth target slightly below the 25% target for 1981. The new target for M2 set in January for the whole of 1982 is 20-22%. This announcement is consistent with the gradualist school of monetary analysis which argues that reducing money growth slowly and gradually will cause least disruption to economic activity, and can enable inflation to decline without too much hardship being caused. It does not seem too far-fetched to imply from the announcement of this target that the theoretical basis for the new policy has quite a wide measure of support among Korean policy-makers.

Second, and perhaps even more important as evidence of the seriousness the Korean authorities are attaching to improved monetary performance is the change in operating procedures announced by the Bank of Korea on January 7th 1982, effective January 8th. Since 1978 the Bank of Korea had been using direct controls on the supply of credit to each sector as the major tool of monetary regulation. The gist of the new policy is that the credit limits which were previously placed on each bank and on each sector will be abolished in favour of an indirect approach to regulating monetary growth (rather than direct regulation of bank credit). The Bank of Korea (BOK) will use orthodox policy instruments such as changes in the discount rate, open market operations, and changes in reserve

SOUTH KOREA
CHART 3 : ACTUAL AND PREDICTED EXCHANGE RATES



requirements to adjust monetary growth. The Bank's open market operations will be conducted through purchases or sales of various kinds of securities - such as commercial paper which has been rapidly gaining popularity recently - to adjust the level of reserve deposits held by commercial banks with the BOK.

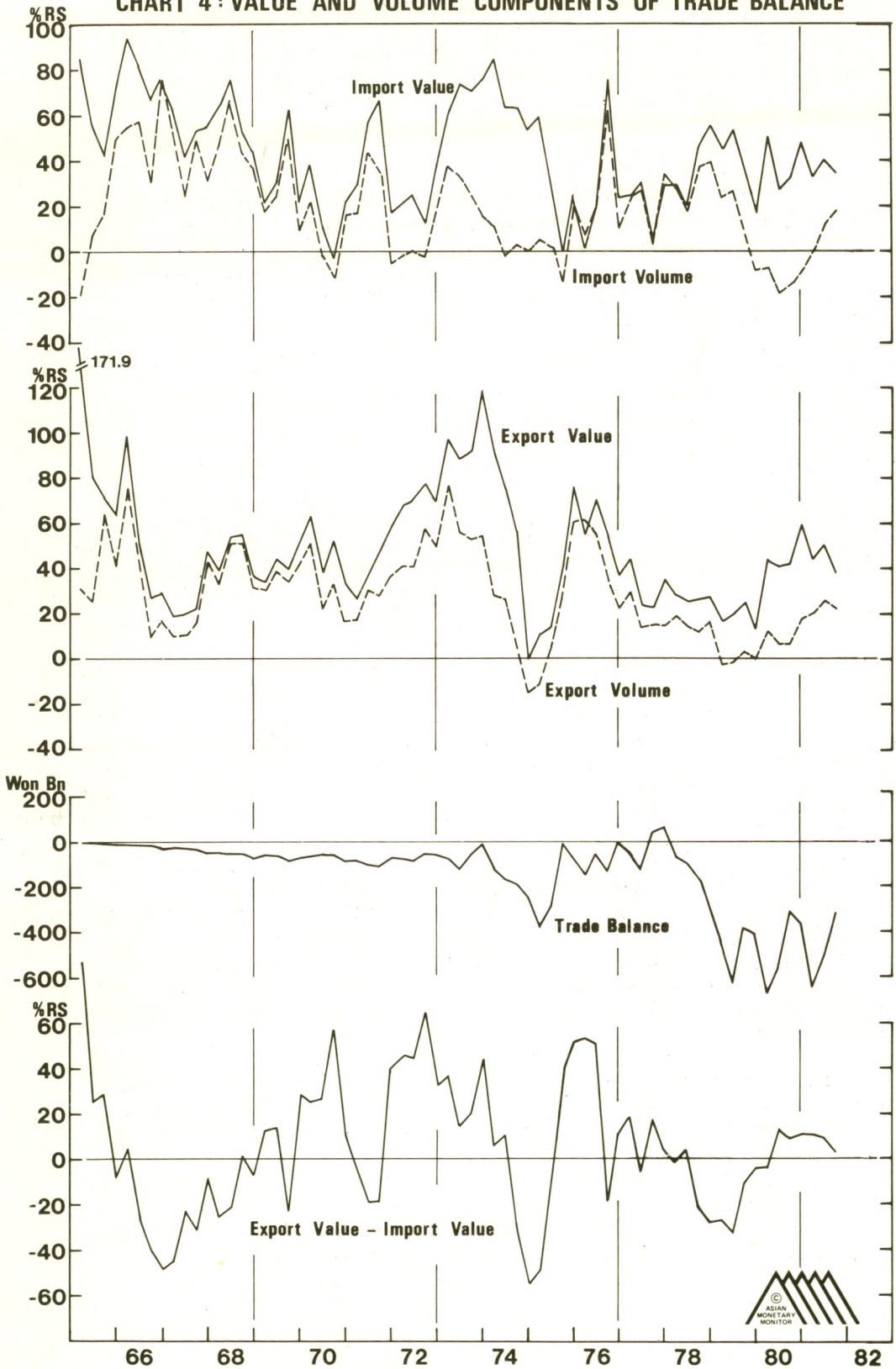
The third and admittedly the least dependable of all these three strands of evidence concerning the earnestness of the Korean authorities to implement a monetarist policy comes from the public statements of government officials. The 1982 New Year has witnessed a stream of such policy statements because President Chun Doo Hwan used the New Year holiday period to relieve Prime Minister Nam Duck-woo of his post, install Yoo Chang-soon in his place, and carry out a major reshuffle of the cabinet ministers responsible for economic policy. The new Deputy Prime Minister and Minister of Economic Planning is Kim Joong-sung, former governor of the Bank of Korea. In his inaugural speech Kim spoke with telling insight of the origins of the 1980 recession: "The economic setback which the nation experienced last year was in great part due to the accumulated side-effects of the preceding high growth which, indeed, produced numerically splendid achievements," but also produced inflation. Therefore, he said, above all else bringing down the inflation rate further will be the first priority of public policy.

The main motive for the reshuffle appears to have been to install a new team of economic experts at the start of the Fifth Five-Year Economic and Social Development Plan which was due to start in 1982. The other economic ministers appointed include Rha Woong-bae as Minister of Finance, Suh Sak-joon as Minister of Commerce and Industry, and Kim Chung-ho as Minister of Construction. But interestingly, no sooner had the new men been installed in office than the Five Year Plan appears to have been set aside. A long term economic blue-print concerning population, land development and technological change to the year 2000 is to be produced in June 1983, but the traditional emphasis of Korean administrations on detailed economic planning appears to have evaporated. To a man the policy statements of the new men since their appointment have echoed the perceptive analysis and understanding of Deputy Prime Minister Kim.

Finance Minister Rha, for example, when quizzed on T.V. about Korea's exchange rate policy said that the government was not going to "depend on easy changes of exchange rates for a boost in exports". He also said that interest rates would not be artificially lowered to stimulate investment. "Only if stable prices are promised" he stated quite correctly, "would the nation have room for further lowering of interest rates". In the same vein Deputy Prime Minister and Economic Planning Board (EPB) chief Kim said that institutional interest rates should be left to the market mechanism rather than being used as a policy tool. On these two key areas of monetary policy - exchange rates and interest rates - it is most encouraging to hear such free market oriented statements. Deputy Prime Minister

SOUTH KOREA

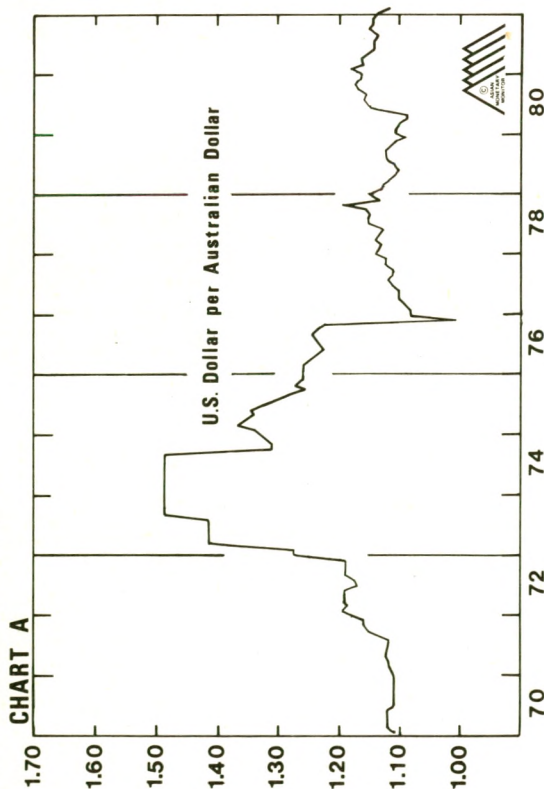
CHART 4: VALUE AND VOLUME COMPONENTS OF TRADE BALANCE



Kim elaborated on this philosophy on January 11th when he told newsmen that no major programme for stimulating the construction market was under consideration as a part of overall economic policy; the business recovery must come of itself and the government's role is only to lead the economy in that direction.

It is tempting to conclude from these public statements on economic policy that Korea now has a team of economic ministers who really understand how to run the economy along monetarist lines, but one must always be cautious about what central bankers and governments say, and pay more attention to what they actually do. It is for this reason that the second strand of evidence - the change in BOK operating procedures - is by far the most convincing of the three. If the BOK continues with these changes in its operating practices (which cover interest rates, exchange rate policy, and money supply policy) then there is a good chance that the discredited old policy pattern - "inflate-devalue-stimulate-inflate-devalue....." will finally be broken once and for all.

FORECAST: Recent changes in the Bank of Korea's operating procedures taken together with a series of public statements by the newly appointed economics ministers suggest that a radical change may have occurred in the management of the South Korean economy. If these new policies are adhered to and prove successful, not only will inflation gradually be brought down, but it will become possible to implement a whole series of steps towards liberalisation of the economy. The exchange rate will no longer need propping up so import controls and inward and outward capital controls could be abolished. Interest rates would be free to fluctuate so the authorities could permit more competition between banks and other financial institutions. As a domestic and international capital market raising funds for businesses in Korea or overseas Seoul would flourish. None of these developments could have been contemplated in the era of rigidly pegged exchange rates. The risks to the exchange rate were simply too great. But the beauty of the new monetarist/free market strategy which appears to have been adopted is that it makes all these goals compatible with a rapid real economic growth rate and a low rate of inflation. If the implications we have drawn from the actions of the Bank of Korea and the new ministers' recent public policy statements are even partially correct, the next few years should see some dramatic changes in South Korea as the economy comes out of isolation and integrates itself more fully with the international financial system.



The continued deterioration in Australia's external account has left the Australian dollar vulnerable to quite large declines against all major currencies over the next six months. This weakness is likely to occur in spite of narrowing interest rate differentials in favour of the Australian dollar (see Chart C). The rise in Australian interest rates will be symptomatic of the potential depreciation of the Australian dollar, and will not, unlike with other currencies, provide a reason for expecting strength in the Australian currency.

As may be seen in Chart A, the Australian economy has been bedevilled by a serious downturn in both its trade and current account. Both the deficits on the balance of trade and on the current account are now at record levels. Moreover these deficits seem likely to continue rising, as witnessed by the 20% growth in imports over the past year in comparison to an unchanged level of exports.

The deficit on Australia's current account is primarily a symptom of the fact that the Australian economy has moved "out of gear" with its major trading partners. The Australian economy is nearly unique amongst the O.E.C.D. economies in that it has not

suffered either a slowdown in monetary growth (see Chart E) or, so far at least, a significant depreciation in its currency against the US dollar. The consequence of this has been a persistent deterioration in sustained weak level of international competitiveness (see Chart D) and an economy where domestic demand is too high, relative to Australia's trading partners, to maintain a balance in Australia's external accounts. This situation will be sustained just so long as monetary growth in Australia remained at an excessive level.

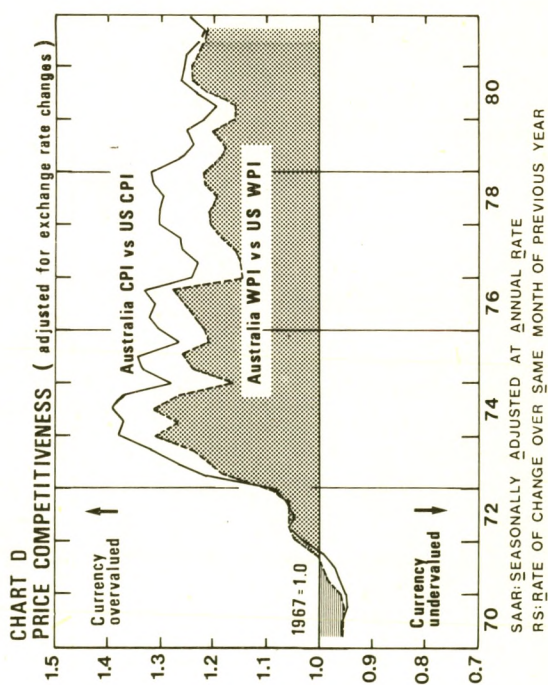
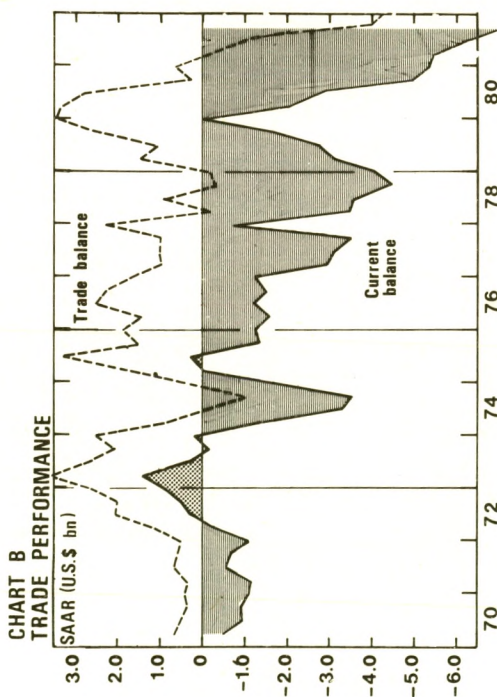
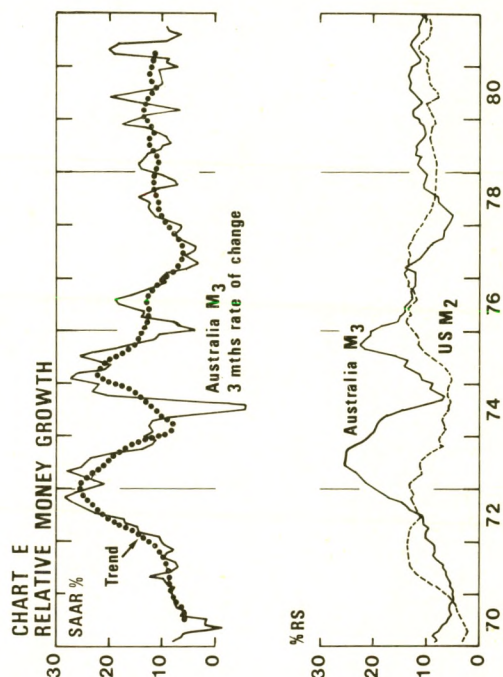
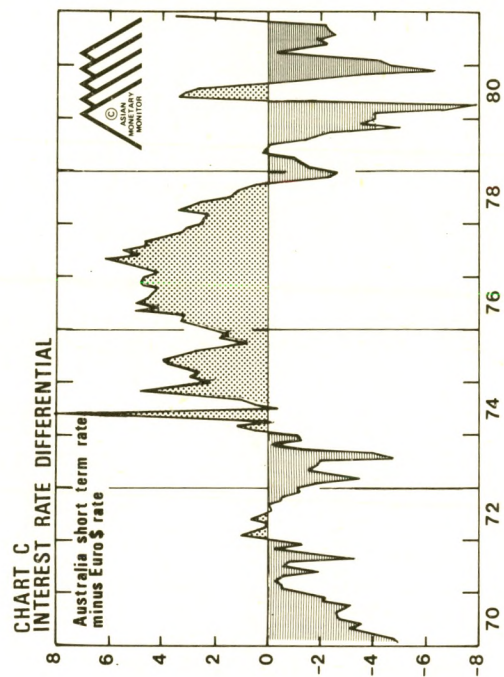
The obvious question to ask at this juncture is why the deficit on Australia's current account deficit failed to promote an overall balance of payments deficit and an external drain on liquidity growth? The answer, almost certainly, lies with heavy private capital inflows into Australia during 1981. These offset the current account deficit, helped sustain monetary growth in the economy, and hence led to even larger current account deficits. This situation has not, and could not have been sustained for the current account deficit has now climbed above the level of the private capital inflows producing an overall balance of payments shortfall. This, in combination with rising inflation, (consumer prices rose 11.4% in 1981) will provide the ingredients for a weaker Australian dollar. A bi-product of Australia's overall external deficit has been pressure on money market interest rates, as monetary growth, at long last, begins to decline in the face of an economy which has only recently begun to slow down.

The Australian dollar will continue to fall against the US dollar at least until US interest rates begin to fall and one should not ignore the possibility of an outright devaluation. In any period of declining US short rates the Australian dollar will be weak against the European currencies and the yen.

US\$/A\$	ACTUAL			FORECAST	
	1981	Q3	Q4	1982	Q1 Q2
FORECAST A				1.14-1.06	1.10-1.02
Actual	1.1585-1.1233		1.1560-1.1254		
FORECAST B				1.14-1.06	1.10-1.06

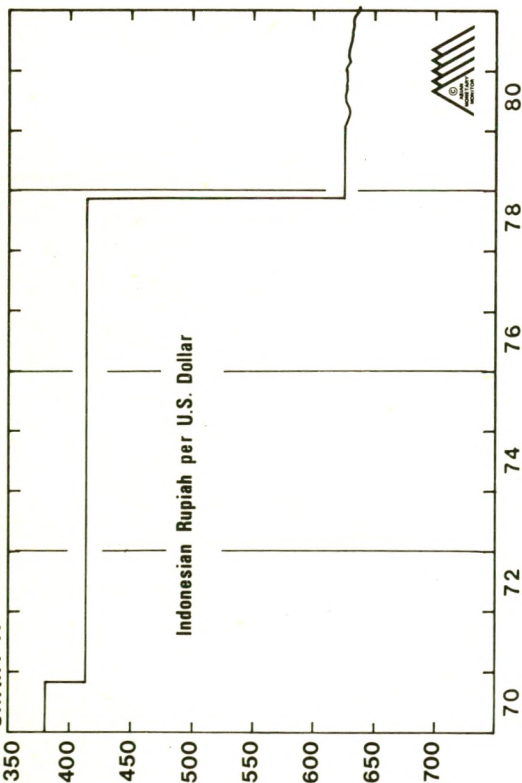
Forecast A assumes that US interest rates remain high, or rise in the first half of 1982.

Forecast B assumes that the recent increases in US interest rates is only temporary, and that they start to decline during the second quarter of 1982.



INDONESIAN RUPIAH

CHART A



During the final months of 1981, there were persistent rumours on the foreign exchanges of an imminent devaluation in the Indonesian Rupiah against a strong US dollar. Nevertheless, the Bank Indonesia steadfastly pegged the Rupiah around Rp. 635 in December, down only slightly from Rp. 625 at the start of the 1981. Has the Bank Indonesia merely postponed the date of devaluation or will it force the Indonesian economy to more fundamental adjustments in line with changing trends in the world's economy?

One piece of evidence that suggests a devaluation may be in the offing is demonstrated in Chart D. This shows that the Indonesian Rupiah may be up to 60% overvalued against the US dollar based on the comparative rates of inflation in each country, after adjusting for the minor depreciation of the Rupiah during the past year.

Chart B also appears to supply a modicum of support for the view that a devaluation of the Rupiah may not be too far off. Indonesia's trade surplus levelled off during 1980 and in the first three months of 1981 (the last period we have data for), and it is argued that the likelihood of further oil price reductions will place the trade surplus under further downward pressure. However a closer look at Indonesia's trade account suggests a somewhat

different story: the fall in price of Indonesia's oil exports has been more than compensated for by rising export volumes and, in fact, the slight reduction in the trade surplus during 1980 was mainly due to a 30% rise in import costs.

The rise in import costs is a lagged reflection of an overly "easy" monetary policy in the two years to mid-1980. In the year to July 1980, M1 in Indonesia had grown by over 50%, and domestic demand pressures had forced inflation up to over 20%. However, since that period the Bank Indonesia has followed a substantially more restrictive monetary policy. The year-to-year growth in M1 has fallen below 30%, with the result that consumer prices rose only a moderate 10.3% in the year to September. With a more restrictive stance by the Bank Indonesia, we would expect economic activity in Indonesia last year to have been lower, and the demand for imports correspondingly reduced.

It seems likely that the course of economic activity in Indonesia during the past two years can best be explained in terms of the orthodox adjustment mechanism in countries with pegged exchange rates. The lower trade surplus was presumably associated with an overall deterioration in Indonesia's balance of payments. This in turn produced the fall in international reserve holdings (Chart C) which was ultimately responsible for slower monetary growth. However, the Indonesian authorities clearly have a long way to go before they can bring the international competitiveness of the Rupiah closer in line with that of the US dollar. In the end, this can probably only be achieved through devaluation, but the Bank Indonesia's recent actions make such an event unlikely in the medium term.

Rupiah/US\$ FORECAST A	ACTUAL			FORECAST	
	1981	Q3	Q4	1982 Q1	Q2
Actual	632.43-633.62			635-640	638-643
FORECAST B	634.13-634.66			850-950	850-950

Forecast A is the most likely range in the absence of a major political or external disruption.

Forecast B is based on a tentative projection of relative price competitiveness depicted in Chart D i.e. the exchange rate required to bring US and local price levels approximately into line.

CHART B

TRADE PERFORMANCE

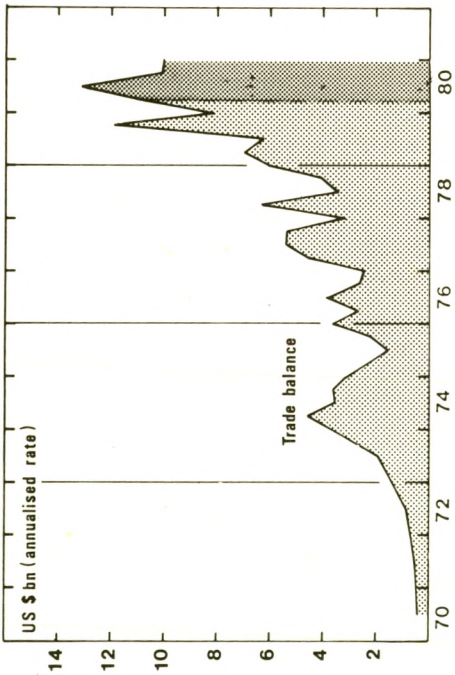


CHART C

INTERNATIONAL RESERVES

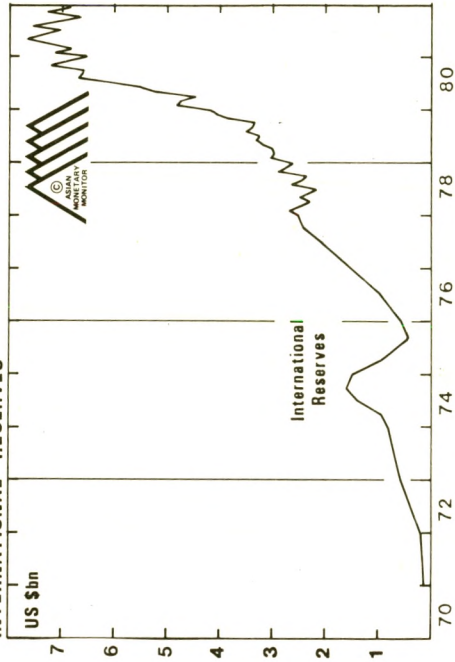


CHART D

PRICE COMPETITIVENESS (adjusted for exchange rate changes)

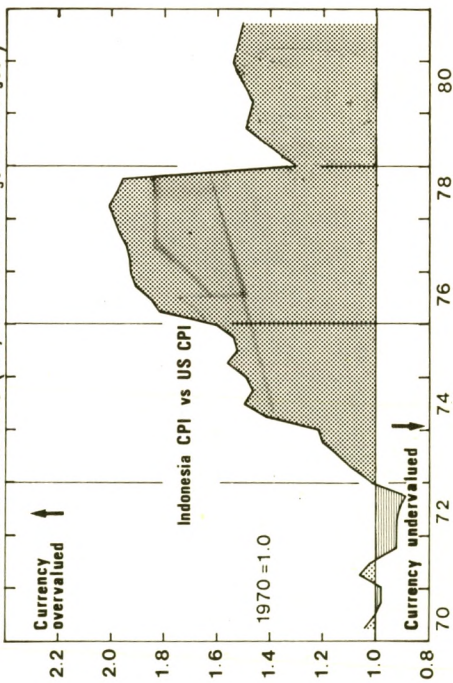
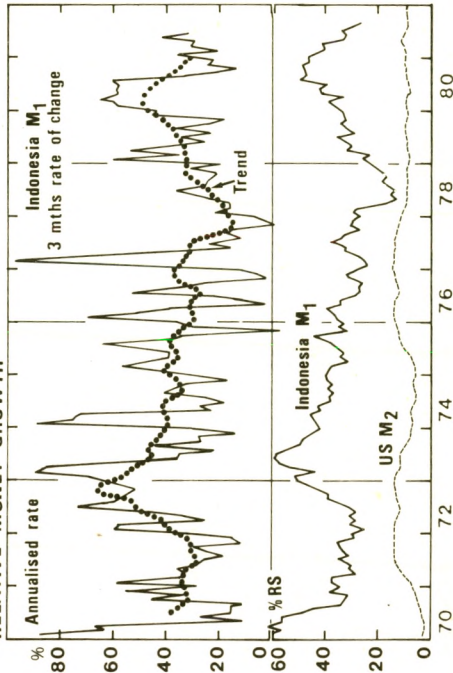
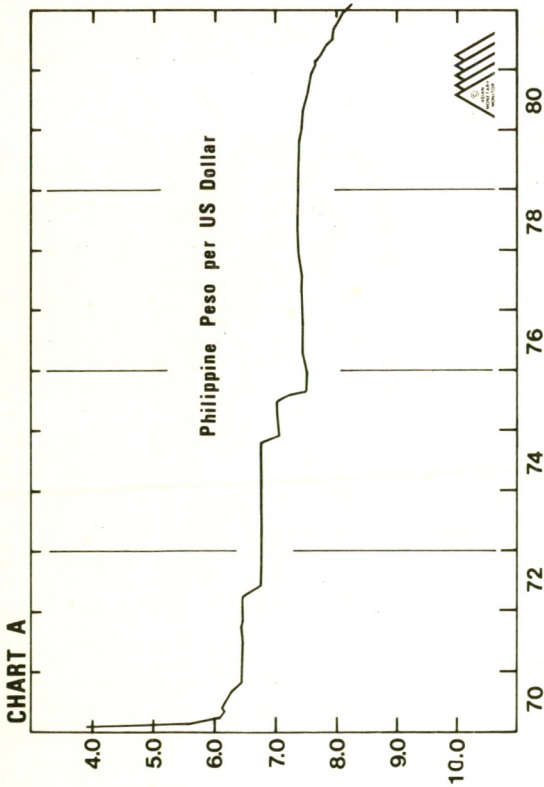


CHART E

RELATIVE MONEY GROWTH



RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR



As forecast in the May-June 1981 edition of AMM the Philippine Peso has continued to depreciate against the US dollar. The Central Bank's guiding rate for the Peso declined below ₱8.00 per US dollar for the first time in September 1981, and the month-average rate declined from ₱7.99 in September to ₱8.06 in October, ₱8.10 in November and ₱8.13 in December. This decline has been so consistent that one can only conclude that it reflects deliberate Central Bank policy.

Underlying the continuous Peso depreciation is a fundamental lack of competitiveness (Chart D) which springs in turn from a persistently high rate of monetary growth in recent years (Chart E). In early 1981 Philippine money markets were shocked by a credit crisis in the commercial paper market when a certain Dewey Dee absconded leaving unpaid debts in excess of US\$70 million. The newly appointed Governor of the Central Bank, Jaime Laya, responded with alacrity, but instead of subsequently calling in the new credits which were made available, the CB appears to have remained fairly accommodative, with money growth (M2) remaining in the 18-20% range for most of the year.

Given the basic lack of international competitiveness the external payments position can only be corrected rapidly by outright

devaluation or by a draconian domestic squeeze. Rather than pursue either of these two painful courses of action the Philippine authorities are arranging numerous loans on the international money markets, as a temporary palliative to shore up the balance of payments, and at the same time they are allowing the currency to depreciate slowly while avoiding any drastic squeeze on the domestic economy.

The combination of continued domestic monetary ease and persistent currency depreciation means that inflation is not falling below double digits. Even with price controls, consumer prices have remained stubbornly in the 11-13% range, and despite falling commodity prices wholesale prices have stayed at 14-15%.

Also symptomatic of the reluctance of the authorities to take proper corrective action is the continuing poor performance on the trade account (Chart B). Exports have been particularly weak since the first quarter of 1981 while imports, though erratic on a monthly basis, have continued to grow. During the first seven months of 1981 imports grew 8.4% on average compared with export growth of 8.8%, but in the period April-July 1981 imports grew by 10.4% over the corresponding period of 1980 while exports declined by 4.5% (all figures in Peso terms).

The outlook for 1982 is for more of the same. Like Korea the Philippine authorities have been allowing the Peso to slide steadily month by month, but unlike Korea one can have very little confidence that a stricter monetary discipline will be imposed. Added to that is the problem that Philippine economic growth is much slower than Korea's, and with world commodity markets set for a period of weakness, the Philippines' export earnings will be much harder hit than the earnings of manufacturing economies like Korea. The Peso is therefore likely to remain persistently weak and to suffer from steady depreciation over the year ahead.

₱/US\$	1981 Q3	Q4	1982 Q1	Q2
FORECAST A				
Actual Range	7.940-8.022	8.035-8.200	8.20-8.45	8.35-8.60
FORECAST B			11.25	11.50

Forecast A is the most likely range in the absence of a major political or external disruption.
Forecast B is based on a simple projection of relative price competitiveness depicted in Chart D i.e. the exchange rate required to bring US and local price levels approximately into line.

CHART B
TRADE PERFORMANCE

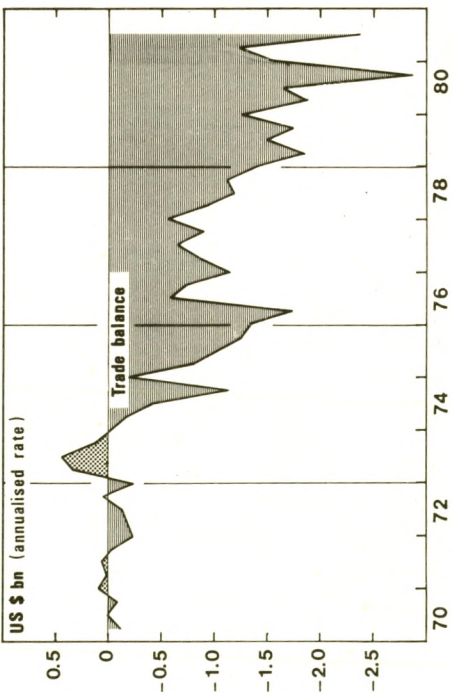


CHART C
INTERNATIONAL RESERVES

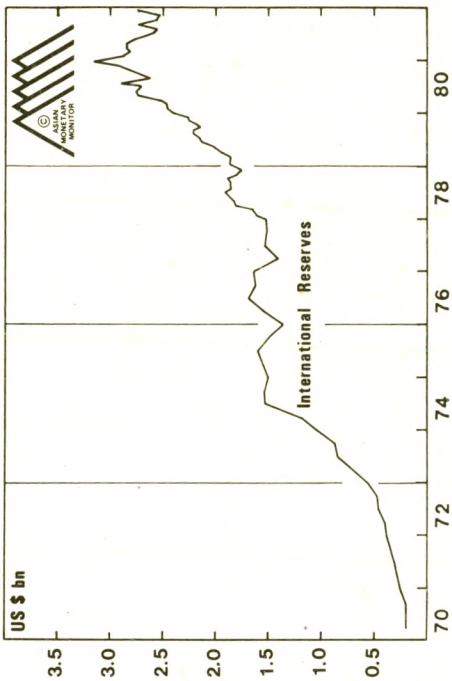


CHART D
PRICE COMPETITIVENESS (adjusted for exchange rate changes)

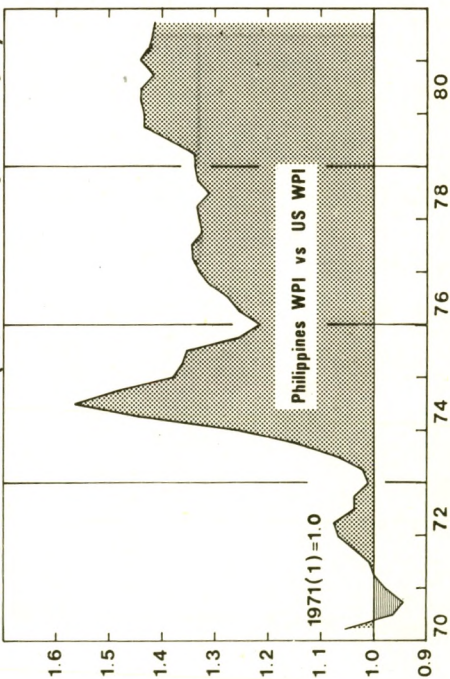
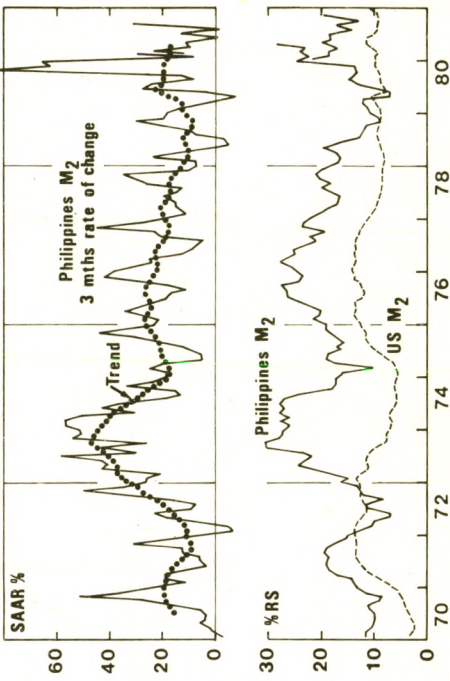


CHART E
RELATIVE MONEY GROWTH



SAAR: SEASONALLY ADJUSTED AT ANNUAL RATE
RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR

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The Prospects for Growth. (5/6)
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A Comparison of Monetary Policy, Exchange Rate Policy, and the Business Cycle in West Germany and Japan. (5/2)
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Devaluation - and now Monetary Restraint? (5/5)

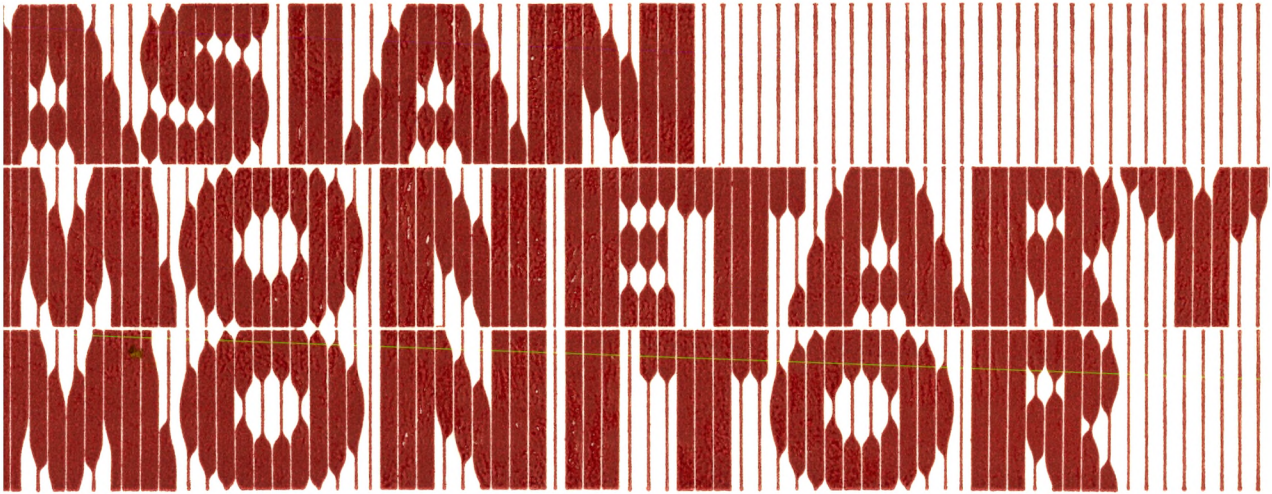
EXCHANGE RATE FORECASTS

(Volume/Number)

	5/1	5/2	5/3	5/4	5/5	5/6	6/1
Australian Dollar	*			*			*
Hong Kong Dollar	*			*			
Indonesian Rupiah							*
Japanese Yen	*	*			*		
Korean Won					*		
Malaysian Ringgit			*				
New Zealand Dollar						*	
Philippine Peso			*				*
Singapore Dollar	*					*	
Taiwan N.T. Dollar							
Thai Baht		*				*	



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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

REGIONAL SURVEY

THE OUTLOOK FOR ASIAN STOCK MARKETS AS U.S. INTEREST RATES DECLINE

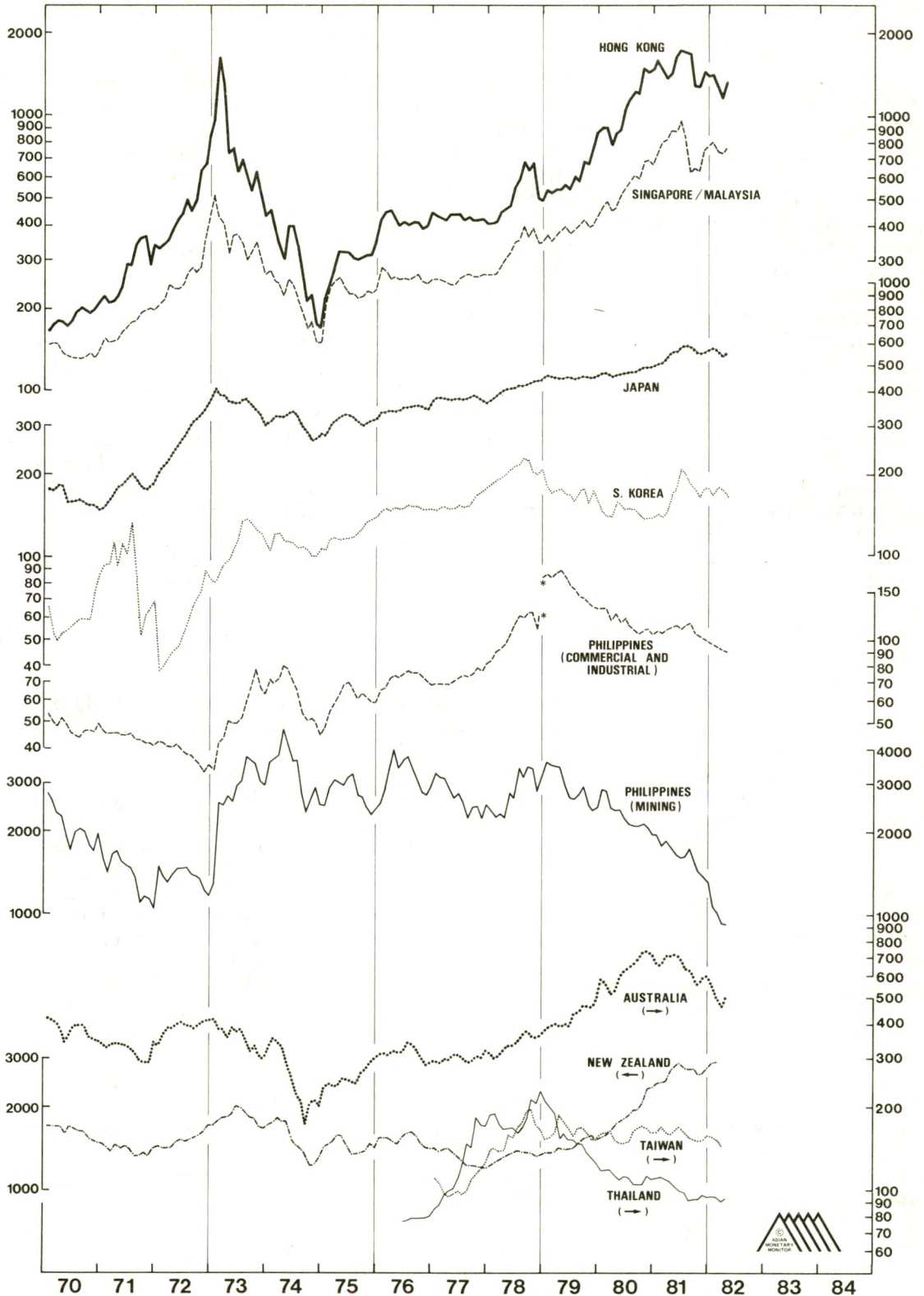
The first months of 1982 have seen weak performances in South East Asian stock markets. After a moderately strong recovery during the final quarter of 1981, regional stock market indices languish at or below the levels reached in September of last year - a period when all major stockmarkets suffered under intense selling pressure. The most recent fall in Asian regional share prices has, once again, coincided with a further period of rising short interest rates in the U.S. This has encouraged a belief that the eventual fall in US interest rates could precipitate a major bull phase in regional stockmarkets.

This view has a certain degree of support from regional stockmarkets' behaviour in previous business cycles. The decline in US short interest rates during the final quarter of 1974 proved to be the start of a rise in regional stock prices which lasted into 1976. More recently, regional stockmarket indices soared following the collapse in US interest rates after credit controls were imposed in March 1980. However, whilst there can be little doubt that declining US interest rates into the second half of this year will do much to enhance confidence in regional stockmarkets, there are important domestic constraints to sustained rises in local share prices. These constraints will not necessarily be alleviated by lower US rates.

In A.M.M. Vol. 5 No. 6, we outlined a number of reasons for expecting slower growth in most regional economies this year. The cyclical downturn will be produced by a combination of deteriorating balance of payment positions, slower monetary growth, continued high inflation and high domestic interest rates. These adverse influences will also impede a strong rise in most regional stockmarkets. This article examines the likely trend in balance of payment positions, monetary growth, inflation and interest rates in comparison with previous cyclical declines in US rates, and assesses their probable impact on stockmarkets in Australia, Hong Kong, Malaysia and Singapore - all important markets for overseas investors.

Before examining these economies in greater detail, two general observations may be noted. First, overall liquidity is "tight" in most regional economies in comparison to previous periods of falling US interest rates: inflation is typically higher and monetary growth generally lower than in either 1975 or 1980, the other two periods of cyclical declines in US rates which we are concerned with. Second, the trend in domestic liquidity in most regional economies compares unfavourably with overall liquidity trends in many European countries. The European economies have typically already endured prolonged recession and are now reaping the benefits in the form of lower domestic inflation and declining interest rates. This has been reflected in the relative performance of their stockmarkets so

CHART 1 FAR EAST STOCK PRICE INDICES



far this year, which have been much superior to the performance of Asian regional markets.

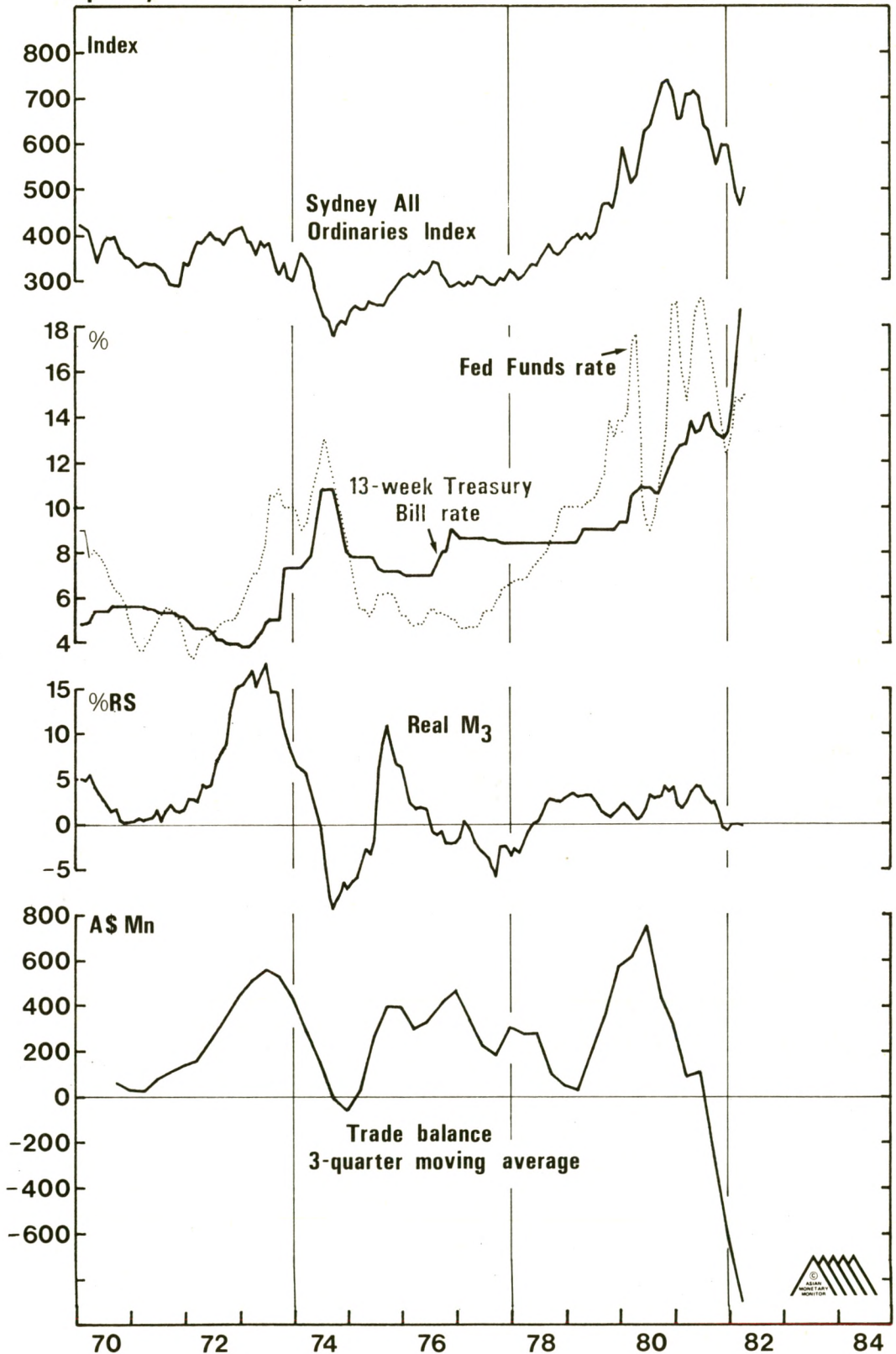
Chart 2 illustrates the performance of the Australian stock market over the last decade relative to the trend in Australia's trade account, domestic liquidity (which is proxied by the yearly growth in M3 deflated by yearly consumer price inflation), and Treasury Bill rates. The performance of Australia's All Ordinaries Share Index is also illustrated relative to the trend in the Federal Funds rate, the most important interest rate in US capital markets. Between September 1974 and 1976, the Australian All Ordinaries Index surged nearly 90%. This sharp rise occurred against a background of a combination of favourable macro-economic influences. Whilst the US Federal Funds rate fell from 13% to 5% during this period, domestic interest rates also declined. Three month Treasury Bill yields fell from around 11.5% to 8.5%. Meanwhile, Australia's balance of trade account, aided by the Australian dollar's 12% devaluation in September 1974, moved back into surplus after recording small deficits during the first half of 1975. Reduced domestic interest rates and an improved trade account encouraged much higher monetary growth. M3 growth soared from 6% year-on-year in the final quarter of 1974 to over 20% year-on-year in the fourth quarter of 1975. With inflation declining in the aftermath of the monetary squeeze of 1974, overall domestic liquidity eased sharply and both the level of economic activity and the stock market recovered.

The precipitous decline in US interest rates during the second quarter of 1980 occurred as the Australian economy neared the crest of its business cycle. At that stage, Australia recorded a record trade surplus with exports boosted by the high level of commodity prices which had not, as yet, responded to the cyclical slowdown in real growth which was emerging in other OECD economies. Domestic interest rates were rising during 1980 but this was primarily a reflection of a higher level of domestic economic activity and rising inflation rather than a meaningful contraction in monetary growth: the Reserve Bank allowed M3 growth to exceed its target for the second year running. Australia recorded one of highest real growth rates in the OECD during 1980 (4%) and the stock market soared once the external constraint, in the form of high and rising US interest rates, was relaxed.

This experience is very unlikely to be repeated during 1982. The recent decline in the All Ordinaries Index reflects growing constraints within the domestic economy as well as adverse external factors, amongst them the prolonged high level of US rates. The most serious problem is the gaping deficit in Australia's trade and current accounts. The current account deficit has precipitated an external drain on domestic monetary growth (the level of Australia's international reserves fell to A\$3.9 billion in January 1982 from A\$5.6 billion in June 1981) which has occurred at a time when Australia's inflation rate is rising. Higher domestic interest rates are a nearly inevitable consequence of the combination of such trends. Tight domestic

Australia : Chart 2

Liquidity Indicators, the Trade Account and the Stock Market



liquidity is unlikely to be alleviated until there is an improvement in Australia's overall balance of payments position. This requires either a relatively prolonged squeeze in the domestic economy or a devaluation, or further depreciation, of the Australian dollar. Neither of these need occur as US interest rates decline.

The economic outlook is broadly similar in Malaysia, as is illustrated in Chart 3. Malaysian stock prices rose quite sharply between September 1974 and the end of 1976, stimulated by a comparable set of favourable macro-economic influences. As in Australia's example, Malaysia's trade account moved solidly into surplus during the latter half of 1975 and 1976 aided, as in Australia, by a "competitive" devaluation of the Ringgit in the second quarter of 1975. The improved trade account position encouraged higher monetary growth (M2 rose nearly 30% during 1976, reversing the deceleration from a year-to-year growth of 35% in mid 1974 to 12% in the second quarter of 1975) which, along with substantially lower inflation - consumer price inflation fell to 1% in November 1975 - provided the basis for a recovery in the Malaysian economy.

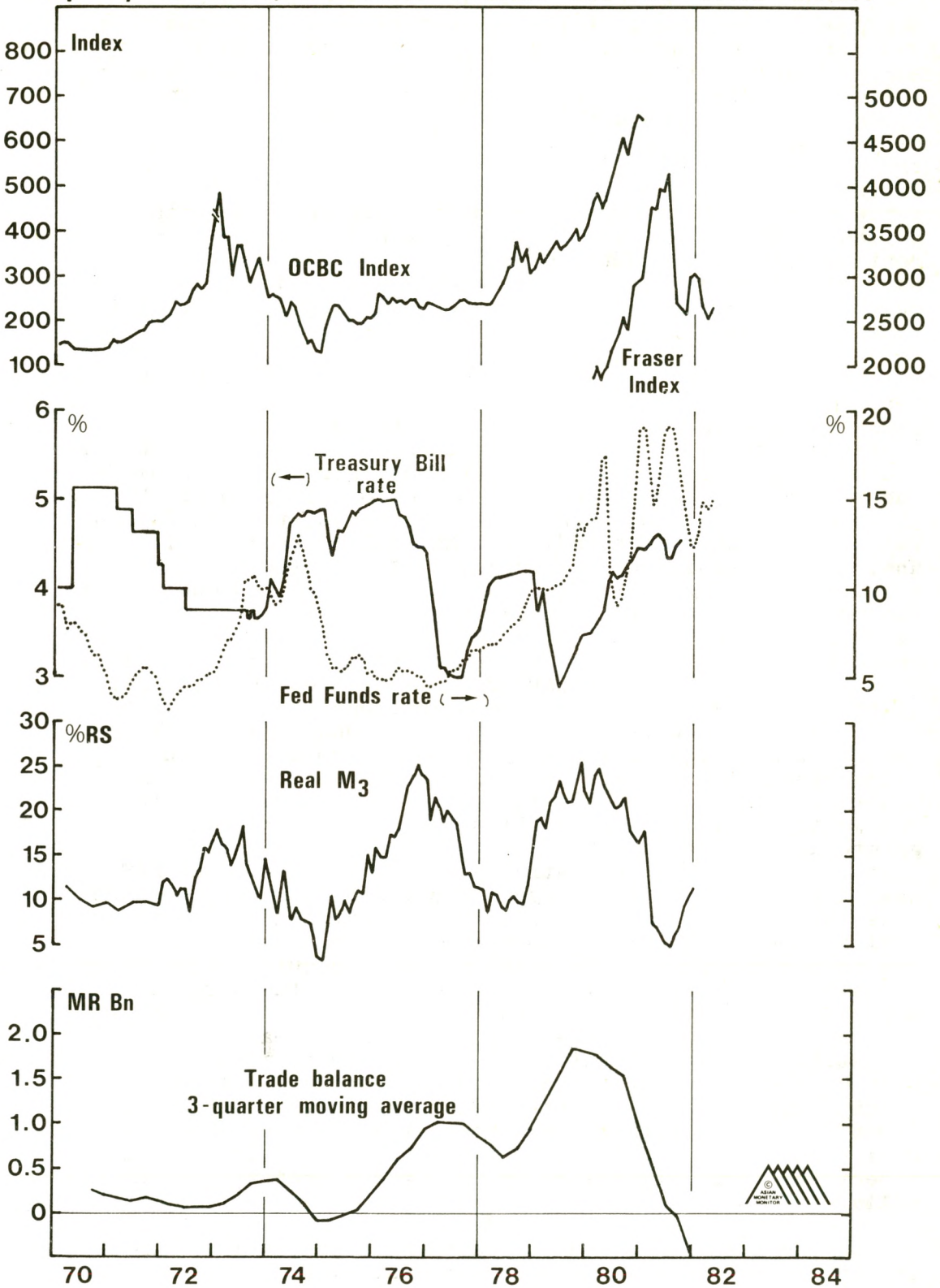
The parallels with Australia's experience may be continued during the 1980 decline in US interest rates. The fall in US rates occurred only marginally before the peak in the Malaysian business cycle. As with Australia, Malaysia's trade account was in record surplus, whilst monetary growth ballooned and domestic interest rates remained close to their historical lows. The Malaysian economy continued to boom, with a real GNP growing 7.1% during the year. However the costs of continued high real growth whilst aggregate demand in Malaysia's major export markets declined was much the same as in Australia: the trade surplus withered into deficit, monetary growth plunged, interest rates rose and domestic liquidity was severely stretched. The prices of many Malaysian stock halved during the summer of 1981 as the outlook for corporate earnings and the economy deteriorated and stock price earnings multiples crumbled.

Although the prospects for the Malaysian stock market indices are marginally more favourable - from a macro-economic view point - than in Australia, they remain unencouraging. Although US interest rates are likely to decline this year it is improbable that this will stimulate a rapid turnaround in the Malaysian trade account. Malaysia, unlike Australia, suffered a severe monetary slowdown during 1981 but the continued deterioration in its trade account indicates that further adjustment in the domestic economy, or in the exchange rate, will be necessary before we may anticipate a sustained easing in local liquidity conditions. So long as the trade account remains in deficit, and providing there is no significant depreciation of the Ringgit, the outlook for Malaysia stock prices is unexciting.

A comparable relationship between US interest rates, domestic liquidity and overall stock market performance has

Malaysia : Chart 3

Liquidity Indicators, the Trade Account and the Stock Market



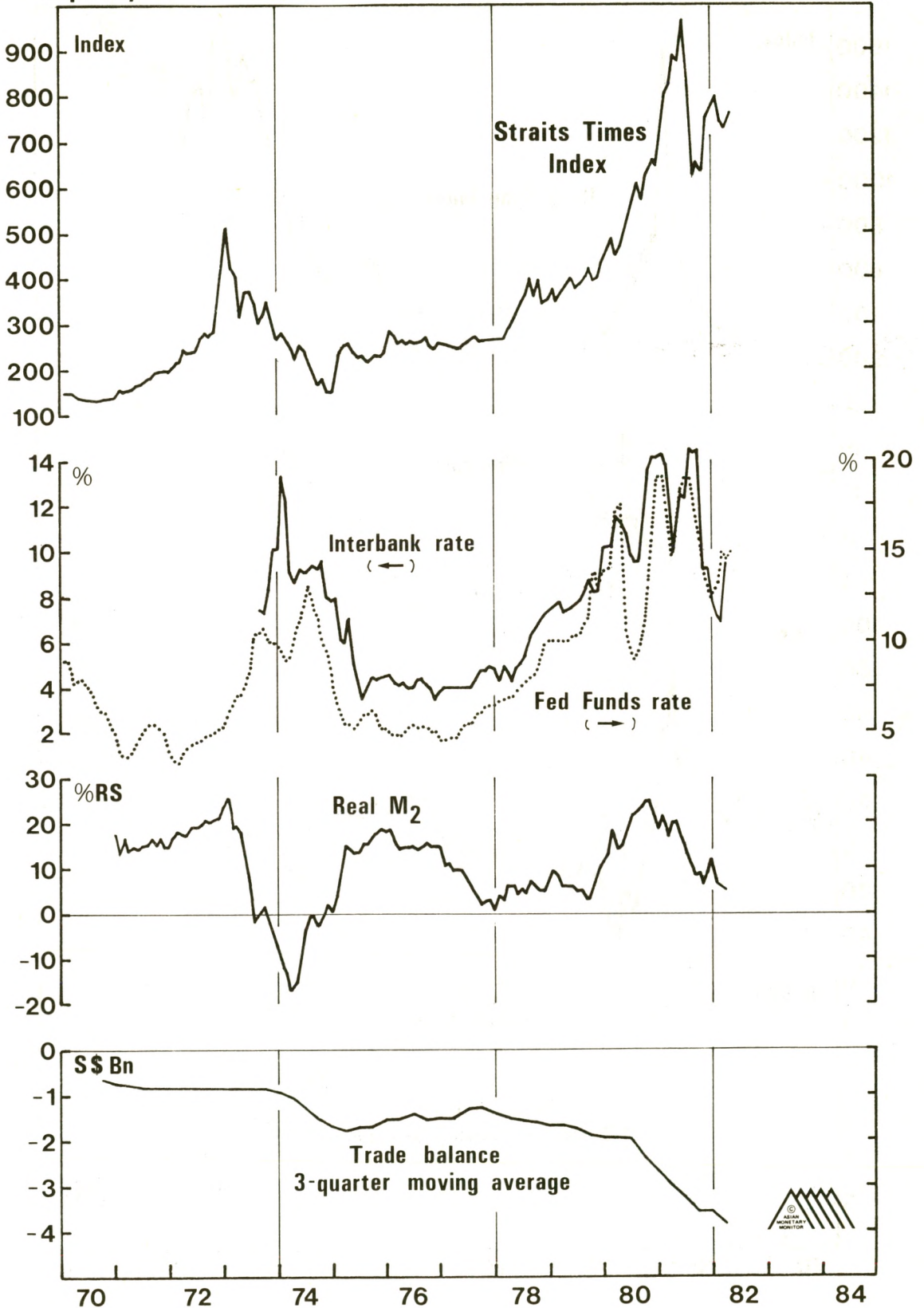
been evident in Singapore. Falling US interest rates from September 1974 through 1976 occurred after a sharp monetary contraction in Singapore and during a period of falling domestic interest rates, declining consumer and wholesale price inflation and accelerating monetary growth. The Singaporean stock market indices naturally performed well under these circumstances with the Straits Times Index rising 65% during the period. The 1980 fall in US rates occurred, as in Australia and Malaysia, just when the Singaporean business cycle neared a cyclical high and property and real estate prices boomed. Once again, the Singaporean stock market continued to rise and the bull market was only broken once a combination of higher local interest rates and a fall in the current account surplus had produced a sharp contraction in domestic liquidity.

A comparison of Charts 3 and 4 indicates that by and large Singaporean stock prices have recovered more rapidly than their Malaysian counterparts. Aside from the relative outlook for earnings growth, and asset valuations, of companies within the two economies there are important macro-economic considerations underlying the superior performance of Singaporean stock prices in recent months. Over the past six months, the annualised rate of consumer price inflation has fallen to 3.3% after a 12% annualised rise in the first half of 1981. The Monetary Authority of Singapore (MAS) has (apparently) responded to this by implementing a more stimulatory monetary policy. M3 rose at an annualised rate of over 25% during the second half of 1981, up sharply from only 8% in the first six months. This easier stance appears to have been maintained into the first quarter of 1982, when Singapore's interbank rate occasionally declined to as low as 1% for overnight funds. The most important question as far as portfolio investors in the Singaporean stock market is concerned is whether this easier monetary stance will be sustained. Two observations are noteworthy in this regard. First, sharply higher monetary growth during the last half of 1981 clearly risks reversing the recent reductions in domestic inflation. Second, the MAS's easier monetary policy in recent months has exacerbated the deterioration in Singapore's trade account, where the trade deficit during the first two months of 1982 rose some 40% over the previous year. It may also be pointed out that after the recent declines in local interest rates and the surge in monetary growth the Singaporean stockmarket has, to a degree, already benefited from the bulk of the MAS's easier stance. Domestic liquidity is unlikely to become very much easier this year unless there is a significant depreciation of the Singaporean dollar. Whilst it is feasible that this is one of the MAS's medium term policy objectives it is unlikely to occur during a period of falling US interest rates where one would expect the Singapore dollar to strengthen against the US dollar.

A characteristic feature of the relatively lack-lustre outlook for stock price indices in Australia, Malaysia and Singapore is that falling US interest need not bring about a strong improvement in the trade and current accounts of these

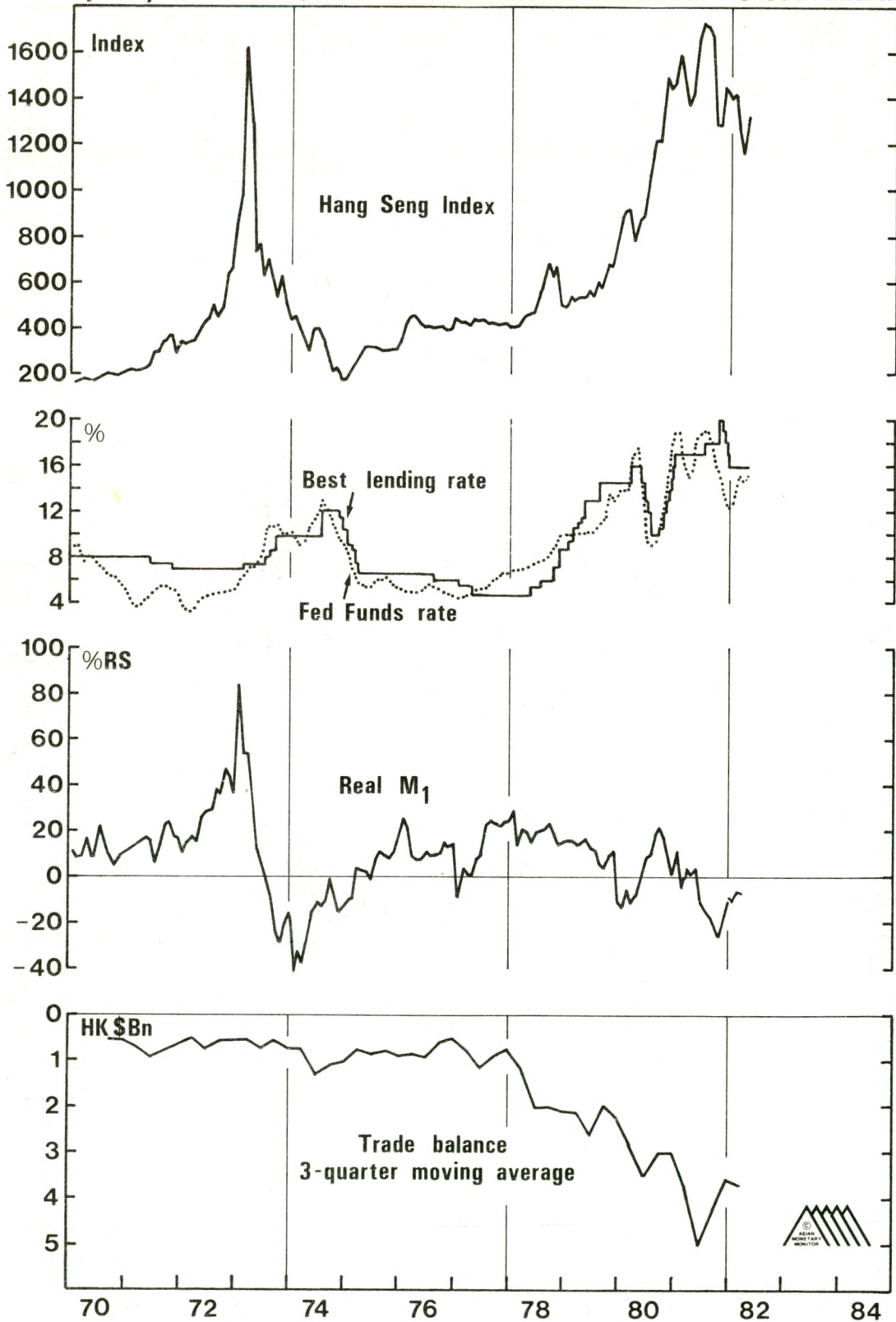
Singapore : Chart 4

Liquidity Indicators, the Trade Account and the Stock Market



Hong Kong : Chart 5

Liquidity Indicators, the Trade Account and the Stock Market



economies. If this proves to be the case, it will be a crucial difference between the period of declining interest rates between late 1974 and 1976. There are a number of reasons why such an outcome is likely. The first, as has been emphasised in this article, is that in this cycle countries such as Australia, Malaysia and Singapore have not yet weathered the severe cyclical turndowns that occurred in advance of falling US rates during 1974. Import growth in these economies has generally remained higher than in 1974 or 1975, and this will retard any recovery in their trade accounts. Moreover there will be important differences in the profile of the US economy during this business cycle which also argue against any rapid improvement in the trade accounts of the countries with which we are concerned. During 1974 and 1975, the decline in the Federal Funds rate signalled aggressive ease by the Federal Reserve, and over the period short interest rates and inflation roughly halved. Meanwhile, M2 growth soared from 6% year-to-year at the end of 1974 to 13% by December 1975. These influences were the major factors behind a very rapid, and ultimately inflationary recovery in the US economy. This quickly generated a recovery in many commodity prices and laid the foundations for a US import boom, with the value of US imports rising more than 30% during 1976. A similar series of events is unlikely this time around. Lower US interest rates will, if the Federal Reserve is to be believed, initially be associated with reduced monetary growth (as and when the US monetary aggregates move back onto target), not higher growth as in previous business cycles. This will tend to prolong a weak level of economic activity in the US this year. In addition it would be virtually inconceivable, in the light of the Federal Reserve's present stance, that the various monetary targets in the US will be raised sufficiently to allow M2 growth to double. This implies that the recovery in the US economy will be promulgated more by lower inflation than by higher monetary growth. One may therefore expect any recovery in the US economy this year to be moderate, which in turn implies that the demand for regional exports and the scope for increases in commodity prices will be limited. These factors will clearly tend to inhibit a rapid turnaround in the trade accounts of countries like Australia, Malaysia and Singapore.

A further constraint lies with differences in exchange rate management policies enforced in the economies under review during 1974/75 compared with the present. As has already been noted the Australian dollar was devalued 12% during September 1974, and then rigidly pegged against a basket of currencies until September 1976. As a result, the Australian dollar depreciated from US\$1.4875 to US\$1.225 over the period. A similar combination of a managed exchange rate policy enhanced by competitive devaluation saw a depreciation from S\$2.225 to S\$2.525 in the Singapore dollar, and from M\$2.225 to M\$2.65 in the Ringgit between the fourth quarter of 1974 and September 1975. These exchange rate management strategies, which occurred as US interest rates declined during the beginning of the recovery in the US economy, were reliable means of enhancing an upturn in the trade accounts of Australia, Malaysia and Singapore. Of course one cannot rule out the possibility of competitive

devaluations/depreciations in these regional currencies during this cycle. Nevertheless, if recent experience is to prove any reasonable guide, regional currencies will tend to appreciate against the US dollar as US rates decline. This was the pattern during the final quarter of 1981. If this is repeated into the second half of this year, the trend in regional currency movements will tend to exacerbate the poor trade positions in the economies with which we are concerned.

It is in this regard that the outlook for overall liquidity in Hong Kong this year is more encouraging than in the other economies reviewed in this article. Prolonged excessive monetary growth between 1978 and mid 1981 produced the easy liquidity conditions necessary to sustain the spectacular bull market in Hong Kong equities over this period. The costs of excessive monetary growth are now well known; a deteriorating trade account, rising inflation and sustained weakness in the Hong Kong dollar. However in recent months these trends have been reversed. Hong Kong has experienced a severe cyclical slowdown in monetary growth since the first quarter of 1981. M1 increased at an average yearly rate in excess of 20% during 1979 and 1980 but declined by 5% in the year to September 1981, presumably in reaction to the sharp rise in local interest rates that occurred in that period. The decline in monetary growth took place against a backdrop of rising inflation and further weakness in the Hong Kong dollar with the result that domestic liquidity growth plummeted. This has been reflected in the trend in property and equity values in Hong Kong, and is illustrated in Chart 5. However the cyclical benefits of the monetary contraction and the recent depreciation of the Hong Kong dollar are now emerging. Inflation in Hong Kong has started to abate and the trade account is showing signs of an improvement. With monetary growth continuing to slow into the first months of 1982 we may expect these trends to be maintained in the medium term. It is therefore reasonable to conclude that the next change in monetary policy will be towards ease. This implies that domestic liquidity in Hong Kong, in contrast to Australia, Malaysia and Singapore, may also ease at approximately the same time as US interest rates decline. To a degree, therefore, economic conditions in the Hong Kong economy are comparable to those evident in the final months of 1974 and in 1975. Hong Kong has already weathered a monetary slowdown, inflation is declining, and the trade account and Hong Kong dollar are displaying signs of greater strength. Hong Kong's stock market indices may well benefit both from declining US interest rates and from a more favourable domestic economic outlook this year.

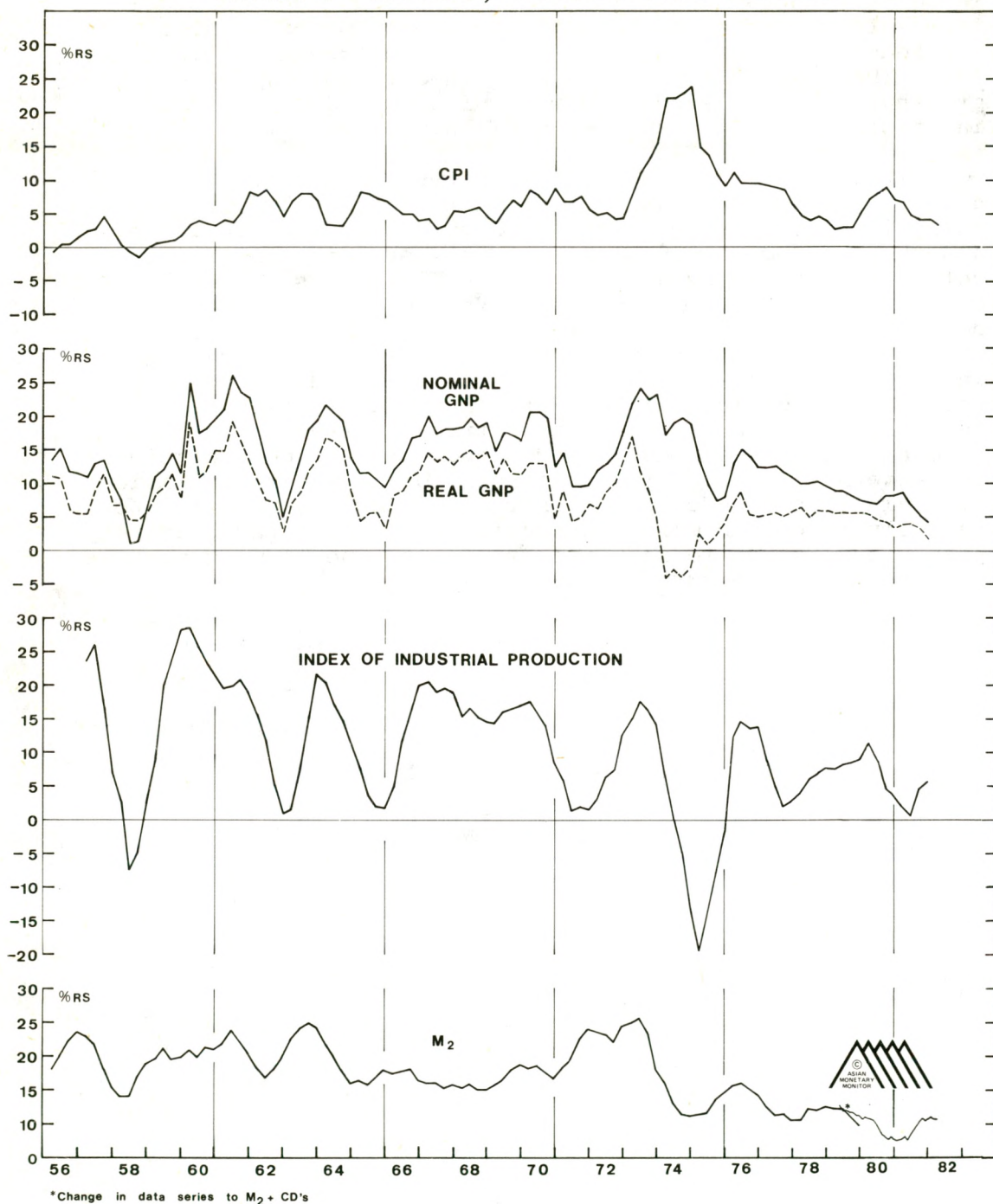
FORECAST: This article has begged the question of whether US interest rates will in fact decline into the second half of this year. However, two of the economic prerequisites are already in place for a cyclical decline in short rates. First, US inflation has declined very significantly over the past two years. US consumer prices rose 14.6% in the year to February 1980, but only 6.7% in the year to March 1982. Second, the level of economic activity in the US remains under pressure.

These influences will allow the Federal Reserve to reduce short term interest rates as US monetary growth moves back to target. The Federal Reserve's more restrictive stance in the January-April 1982 period is reliably designed to curtail monetary growth during the second quarter of this year. Short US interest rates are likely to decline as a result.

This decline in US interest rates is unlikely to generate a very strong performance in stock market indices in Australia, Malaysia or Singapore. The stock market indices must overcome a number of domestic obstacles to higher prices, and these need not be alleviated by a reduction in US interest rates. Broadly, domestic liquidity in Australia, Malaysia and, to a lesser degree Singapore is likely to remain, or to become restrictive. This will occur, principally, because of a deteriorating trend in these countries' trade accounts. It would be necessary to review this conclusion, however, in the event of a significant depreciation in any of these countries' currencies. Hong Kong, in contrast, has already experienced a marked depreciation in the external value of the Hong Kong dollar. With inflation declining, the trade account strengthening and monetary policy unlikely to become more restrictive, one may expect the Hong Kong stock market to rank amongst the top performing markets this year when measured in US dollar terms.

JAPAN

CHART 1 : MONEY, OUTPUT AND PRICES



JAPAN

UNWARRANTED PESSIMISM

The basic principles of economic management in Japan are relatively straight-forward to explain. The Bank of Japan attempts to follow an independent monetary policy designed to keep domestic inflationary pressures at a low level and to encourage stability in nominal income growth. The first of these objectives has been achieved by maintaining growth in the monetary aggregates at a moderate level. The second, by ensuring that cyclical swings in monetary growth are relatively modest and predictable. A necessary condition for the attainment of both these is that the yen is allowed to float relatively freely on the foreign exchanges. This gives the Bank of Japan the independence to pursue a conservative monetary policy - irrespective of the type of policy other central banks may follow - and also helps to insulate the economy from the cyclical upswings and downturns that inevitably follow swings in the balance of payments in pegged exchange rate countries.

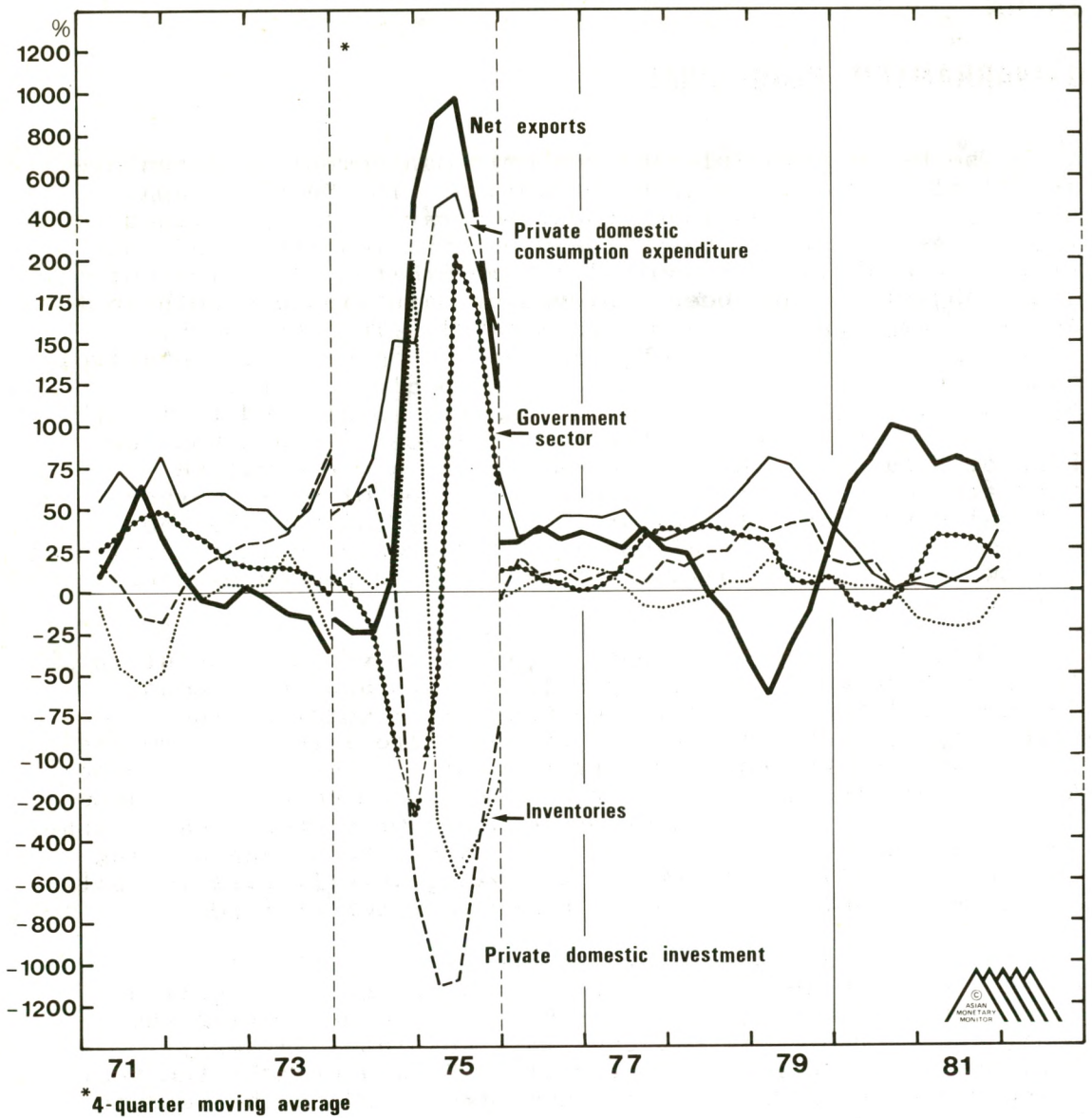
This fundamental economic strategy proved successful in the period between the second half of 1975 and the second quarter of 1981, certainly (see Chart 1) insofar as the stability of overall real GNP, the moderate level of domestic inflation and the long term strength of the yen are concerned. As is widely recognised, Japan's overall economic performance during this period was superior to other OECD economies. Japan achieved a high, stable real growth rate without aggravating domestic inflation, whilst the yen was generally firm in spite of the relatively low level of domestic interest rates.

Over the past nine months, however, the efficiency of Japan's basic economic management strategy has been called into doubt. The 0.9% fall in real GNP recorded during the fourth quarter of 1981 was the first absolute quarterly decline since the first quarter of 1975, and brought the year-to-year growth in GNP to 1.6%, down from 3.2% in the year to March 1981. Moreover, since the second quarter of 1981 the yen's disappointing performance on the foreign exchanges has confounded commonplace optimistic forecasts for the Japanese currency. The combination of an unexpectedly weak performance in the yen and the slowdown in real growth represent a significant change in fortune for the Japanese economy. This was reflected in a sharp decline in Japanese stock prices during the first quarter of 1982.

In seeking to explain this fracture in Japan's hitherto solid economic performance it is essential to realise that although real GNP growth in Japan has, until recently, been remarkably stable the components of growth have exhibited sizeable deviations from trend. Chart 2 demonstrates the large changes in the contribution to real growth from different sectors in the Japanese economy during the past ten years. All variables are measured in real terms. Chart 2 shows the

JAPAN

Chart 2: Sectoral Contribution to Real Growth



relative influence of the domestic private sector, the external sector, and the government sector on overall real growth in each four quarter period since the start of 1971. For example, during 1977 private domestic consumption contributed 30% of the real growth in the Japanese economy. Chart 2 also reveals that the government sector provided a major source of real growth in 1977, whereas investment in inventories actually reduced overall real growth 8% below what it would otherwise have been had both private sector and government holdings of stock inventories remained unchanged (in real terms) during the year.

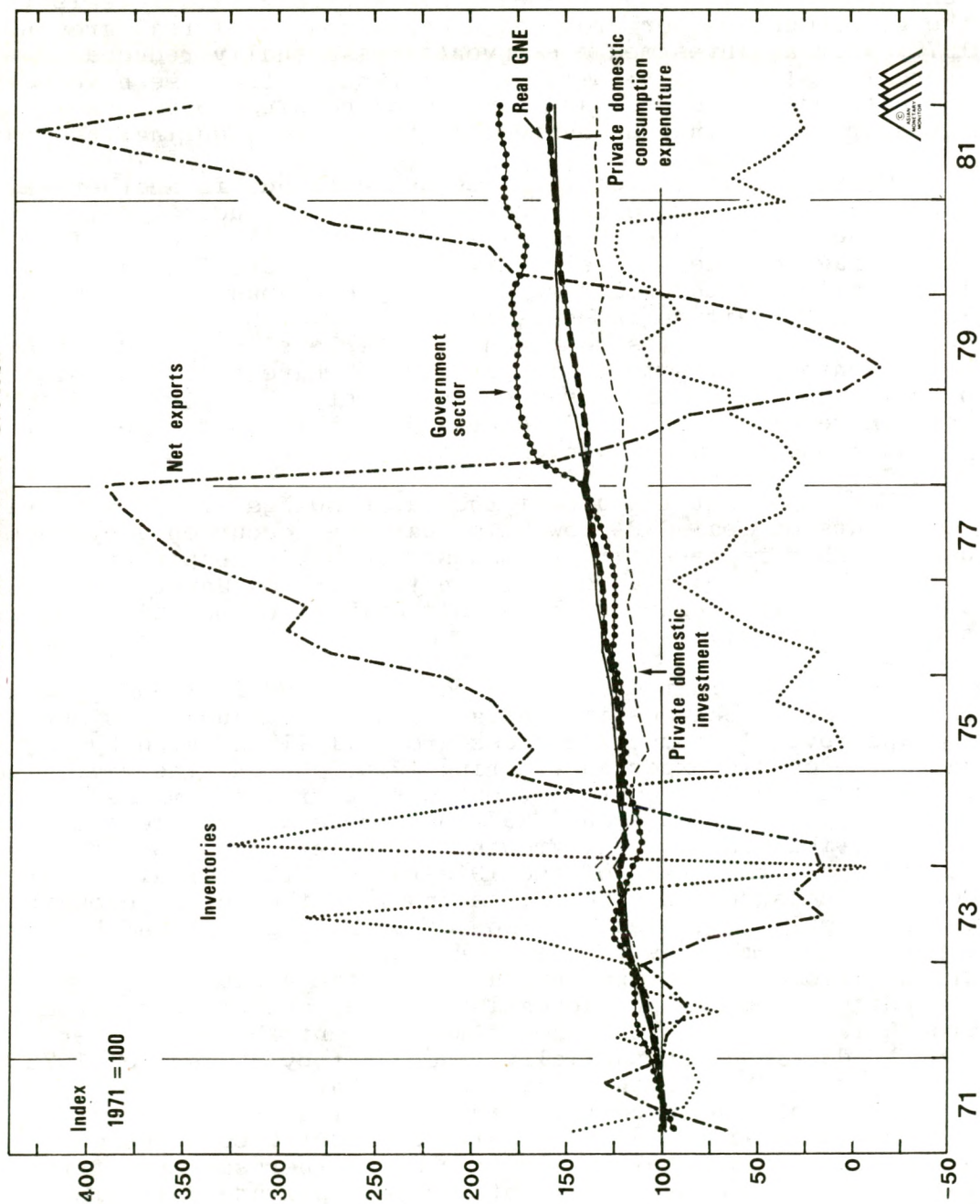
Chart 3 illustrates the same basic trends in another way. Chart 3 shows the absolute increase in the principal components of Japanese GNP since 1971. The series are all indexed from the average of their levels during 1971. Chart 3 is a dramatic illustration of the relative stability of Japanese real Gross National Expenditure in spite of very large changes in the absolute levels of its components. The level of net exports and inventory investment, in particular, have varied considerably over the course of the business cycle but, as in 1978 and 1979, there have also been significant adjustments to the level of private consumption and investment.

The important feature of the large swings in the sectoral components of real GNP growth is that they occur on a cyclical basis. They represent the Japanese economy's response to stimuli both from broad changes in the Bank of Japan's monetary policy, and from changes in Japan's overall competitiveness in the world economy.

Variations in the sectoral components of real GNP growth in response to changes in central bank policy and adjustments to Japan overall competitiveness are well illustrated by Japan's economic experience during 1978. During the year, the government sector's contribution to real growth remained relatively steady at around 25%, but there were large swings in the contributions to real growth from other sectors in the economy. At the start of the 1978 the growth in real private domestic consumption expenditure and in net exports accounted for a roughly equivalent portion of overall growth in the Japanese economy. As the year progressed, however, it is evident from Chart 2 that private domestic consumption expenditures became an increasingly important source of real growth in Japan. At the same time the contribution of net exports declined substantially, such that by the end of 1978, overall real GNP growth in Japan would have been some 50% higher without the (negative) impact of the external sector. The increasing importance of private domestic consumption expenditure during 1978 was mirrored in other sectors of the domestic economy: by the end of the year private domestic investment expenditure and investment in stocks of inventories accounted for nearly half of real GDP growth in Japan.

These shifts in sectoral contributions to overall growth occurred against the background of a major cyclical change in the Bank of Japan's monetary policy and a decline in the international competitiveness of the yen - which appreciated

JAPAN
Chart 3: Indices of Sectoral Growth



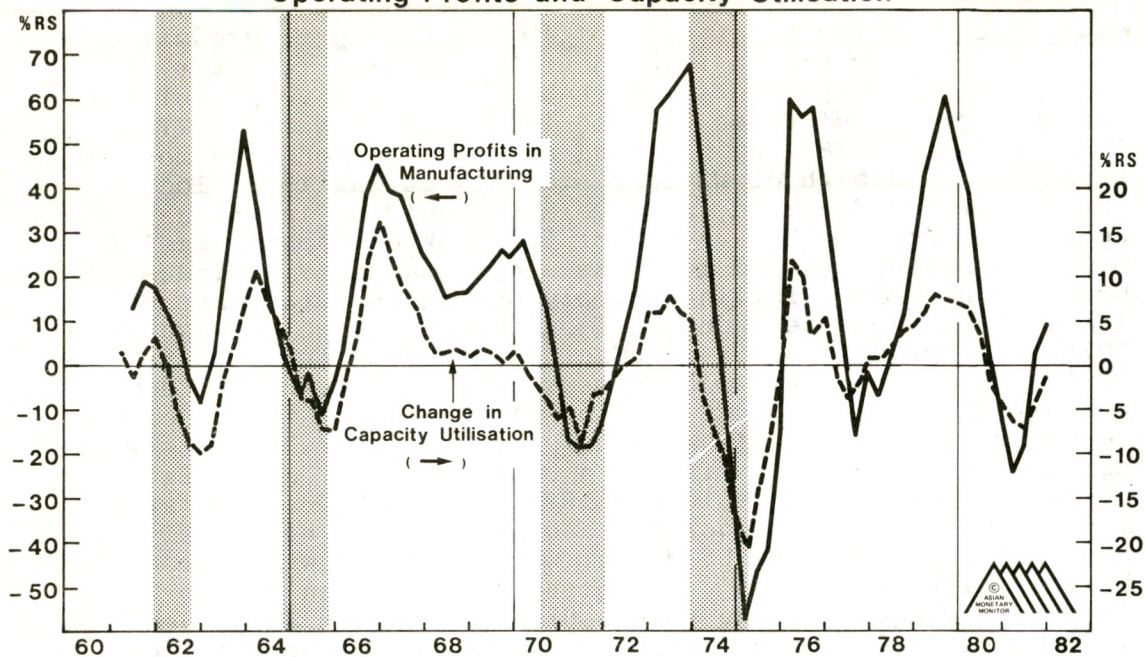
sharply during the first half of 1978. Having progressively reduced monetary growth throughout 1977 (refer to Chart 1) the Bank of Japan responded to the subsequent decline in inflation - consumer price inflation dropped from 9.4% in March 1977 to 4.6% in March 1978 - by adopting a more accommodative monetary stance. The growth of M2 rose steadily during 1978, local interest rates declined, and overall liquidity in the Japanese economy improved. One result of the Bank of Japan's easier monetary posture was to generate a cyclical rise in industrial production. After falling sharply during 1977 the rate of increase in Japanese industrial output recovered throughout 1978, with production in manufacturing and mining industries rising 8% in the year to December. The pick-up in the domestic economy encouraged import growth which enhanced the underlying deterioration in Japan's external account, where exports were already beginning to suffer as a consequence of a relatively overvalued yen. (By September 1978 the yen had appreciated to Yen 190 against the US dollar, and appeared to be roughly 10% overvalued against the US dollar when compared with Purchasing Power Parity estimates. The strength of the yen was an important reason why the volume of exports from Japan declined 10% during 1978.) The crucial point to notice here is that in spite of significant changes in important economic variables - monetary growth, interest rates, and the exchange rate - and large swings in the various sectors of the Japanese economy, overall real growth was stable, at between 5% and 5½%, throughout the year.

The lesson from Japan's experience during 1978, and in the ensuing two year period is that the process of economic adjustment in the Japanese economy occurs, predominantly, through cyclical changes in the sectoral composition of GNP. This analysis points the way to the correct explanation for the decline in real growth in the Japanese economy during the past nine months, and has important implications for likely economic trends in Japan during the remainder of 1982.

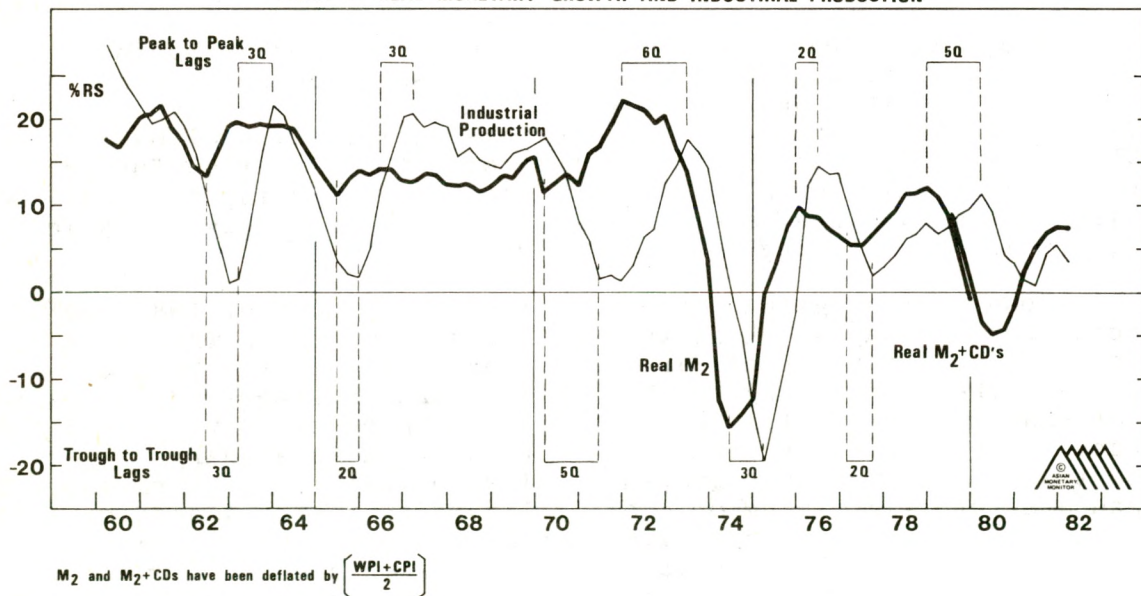
Reduced real growth in Japan since the middle of 1981 has occurred in a way which is very different from the downturn in economic activity typical in other countries. In the United States, the United Kingdom, West Germany and Switzerland, for example, the profile of recession has been similar. In each case concerted central bank action produced a sharp contraction in monetary growth, rising nominal interest rates and a severe tightening of overall liquidity in the domestic economy. The policy objective in reducing monetary growth was to encourage a decline in inflation. In each country, however, the cost of this approach was a concomitant decline in the level of economic activity. In Japan, by contrast, the decline in real growth has occurred against the backdrop of rising monetary growth falling nominal interest rates and an existing modest level of inflation.

A description of the decline in real growth in Japan during the second half of 1981 is straightforward. Real growth slowed as Japanese net exports - which had been responsible for virtually the whole of real growth during

JAPAN : CHART 4
Operating Profits and Capacity Utilisation

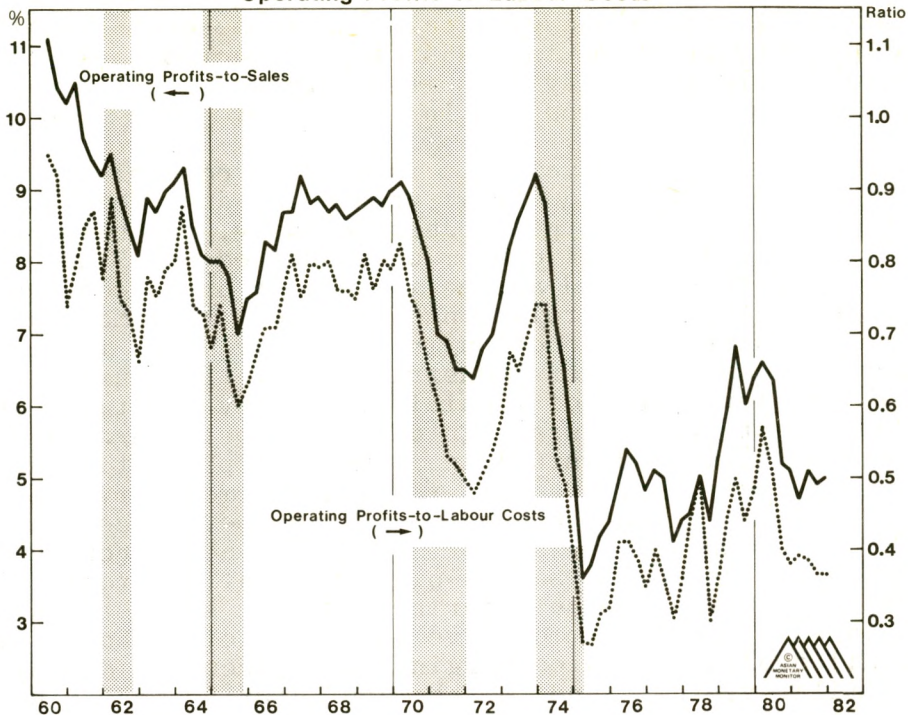


JAPAN
CHART 5: REAL MONETARY GROWTH AND INDUSTRIAL PRODUCTION



JAPAN: CHART 6

Ratios of Operating Profits-to-Sales and Operating Profits-to-Labour Costs



1980 - declined in the face of falling export growth and a moderate increase in imports. Nevertheless, this does not really present an adequate explanation of reduced growth in Japan. One must be circumspect in accepting the argument that "Japanese growth is export-led". Although Chart 3 illustrates that, at present, Japanese net exports have grown considerably faster than real GNE since 1971, it is also apparent, both from Chart 2 and Chart 3, that the sharp decline in net exports during 1978 and 1979 was compatible with continued high growth overall. At that time, the decline in net exports was compensated for by a cyclical revival in the domestic sectors of the economy. Thus the important question concerning weaker real growth is: why has the domestic sector failed to recover in spite of a favourable trend in domestic liquidity?

In reality, there are already tangible signs of an incipient recovery in the domestic sector of the Japanese economy. The evidence for this is illustrated in Charts 4 to 7. Here we have displayed the trend of various economic variables relating to the industrial sector and to the labour and consumption markets. Chart 5 displays the relationship between monetary growth - adjusted for changes in consumer and wholesale prices - and industrial production in Japanese business cycles since 1960. This in turn can be related to changes in capacity utilisation and to cyclical swings in profitability in Japan's manufacturing industry. The trend in these variables is portrayed in Chart 4. It is evident that a rise in real money growth has always presaged an increase in

industrial production. In 1978, for example, the combination of falling inflation and a cyclical rise in monetary growth sparked a strong recovery in industrial production and manufacturing profitability in spite of the pronounced downturn in exports growth that occurred in that year.

Similarly, in this cycle, it is already possible to detect the lagged response of industrial production and profitability to "easier" liquidity in the Japanese economy. Industrial production growth has, of course, been subdued over the past six months but this should not be a cause of undue concern. The lags implicit in the relationship between real monetary growth and industrial production in Japan may allow for temporary periods of weaker industrial production during cyclically easier levels of liquidity. In any event, if the evidence of past cycles is any guide, one should in no way anticipate a cyclical downturn in industrial production until there is a change towards a more restrictive monetary policy by the Bank of Japan. Chart 6 provides further evidence that a recovery in the industrial sector of the Japanese economy may be under way. The stabilisation of the operating profits to sales ratio of Japan's manufacturing industry suggests that the Bank of Japan's more accommodative monetary policy has stemmed the overall decline in sales margins which occurred during 1980. Similarly, the trend in the manufacturing sector's operating profits to labour costs ratio implies that the worst of the decline in productivity has already occurred.

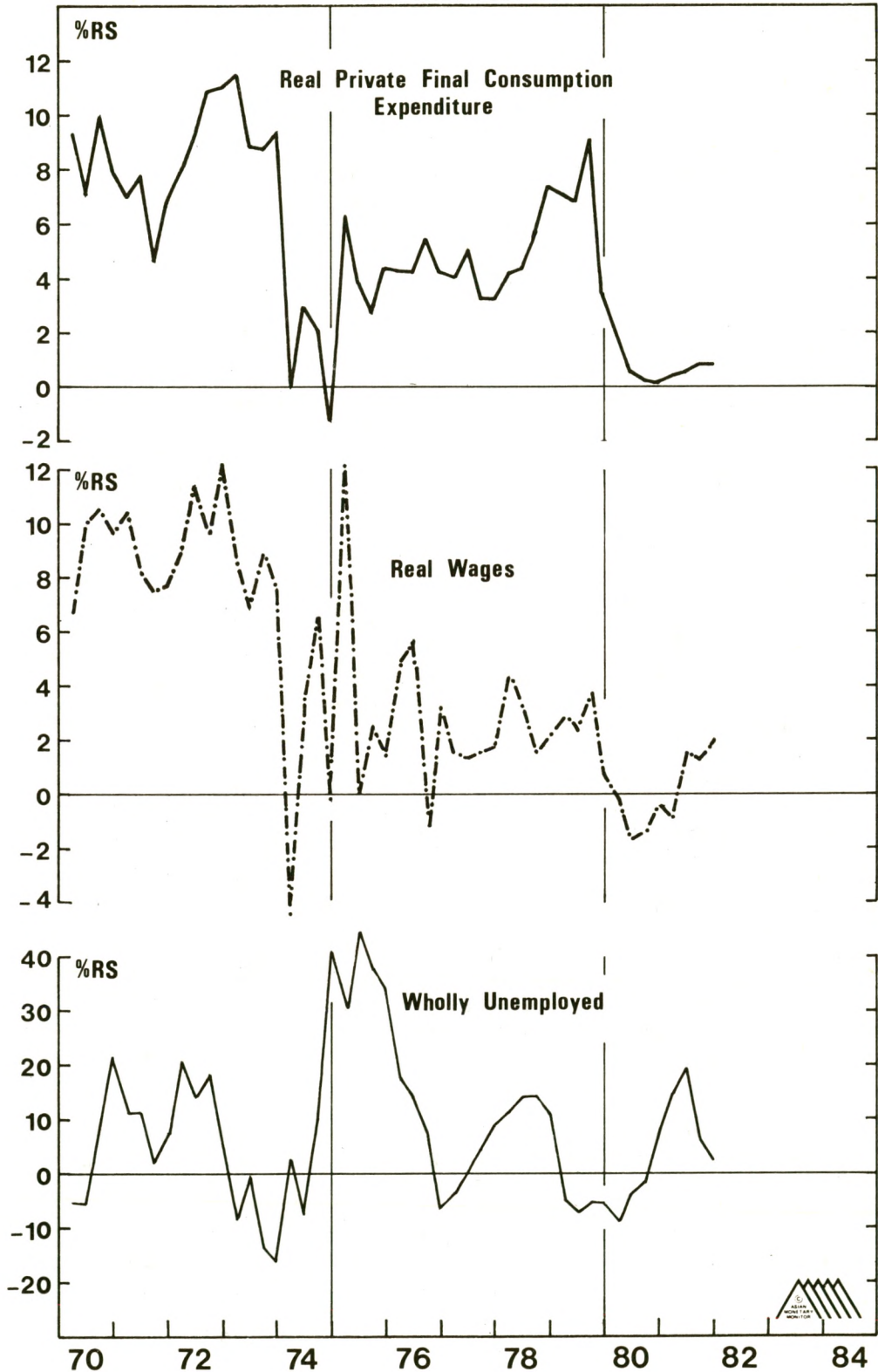
The lessons from previous business cycles indicate that the impact of easier liquidity in the Japanese economy will not be confined to the manufacturing sector of the economy. Real wages and private domestic consumption expenditure are also likely to benefit from the Bank of Japan's easier monetary stance. Chart 7 illustrates the slight improvement in real private consumption expenditure which occurred during the second half of 1981. This is likely to continue given current Bank of Japan policy, and Chart 7 also suggests that real wage growth has troughed while the underlying condition of Japan's labour market is starting to improve.

Thus it seems that the domestic sector of the Japanese economy is already starting to 'take over' from net exports as the principal component of growth in real GNP. We have argued that this change in sectoral contribution to real growth is predominantly a cyclical response to cyclical adjustments in the Bank of Japan's monetary policy and broad swings in the overall competitiveness of Japanese output as measured by the trend in the trade account. In this respect, the prospects for the Japanese economy during 1982 appear very similar to those encountered in 1978: the Bank of Japan's monetary policy is relatively accommodative, nominal interest rates have declined, inflation continues to fall, whilst the underlying trend in net export growth is deteriorating. On this basis one should anticipate further gains in the domestic economy during the course of the year.

Nevertheless, there is a further question to be answered in regard to the reduction in overall real GDP growth in the

JAPAN

CHART 7: REAL PRIVATE CONSUMPTION, REAL WAGES AND UNEMPLOYMENT



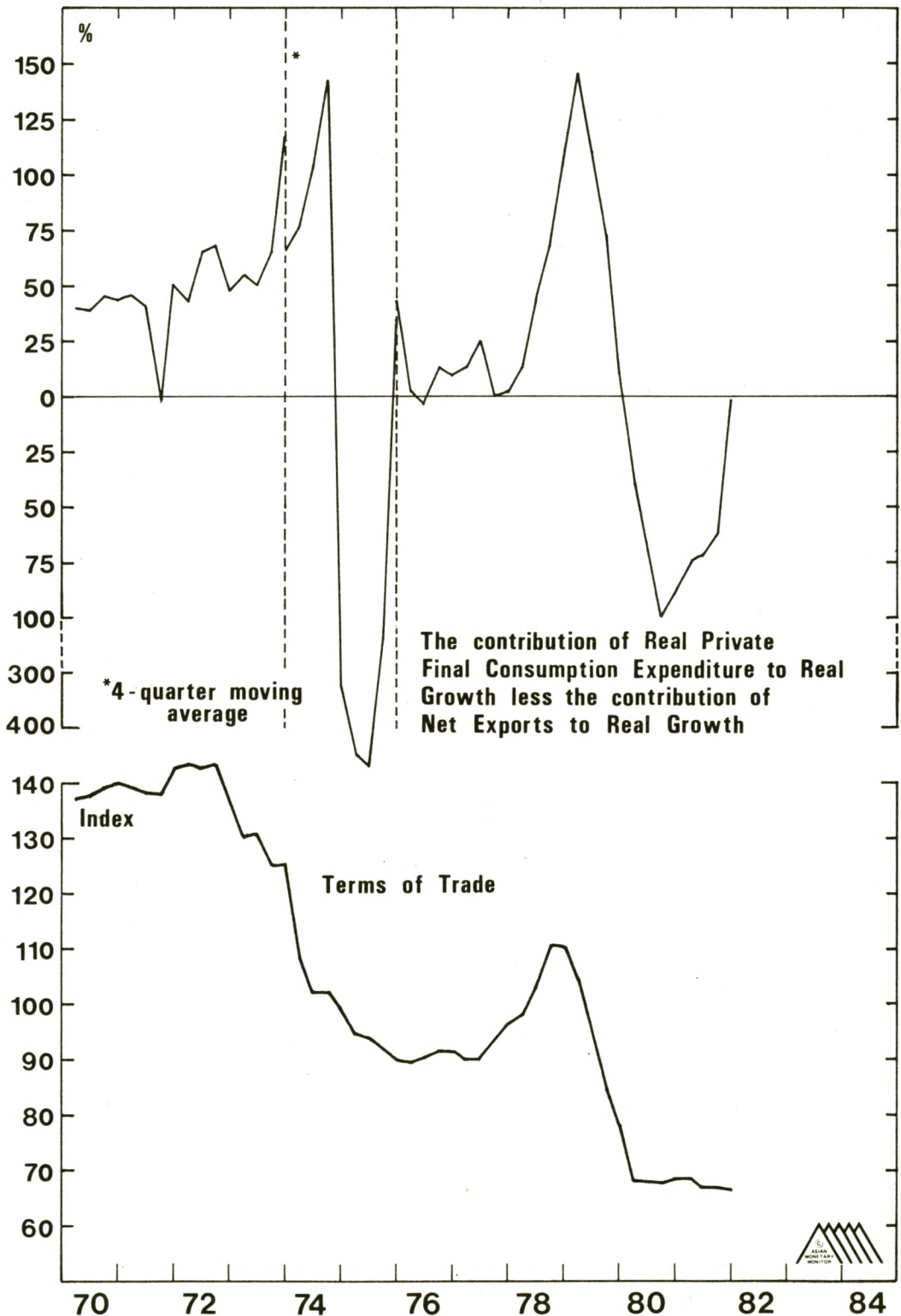
second half of 1981. Although the domestic economy looks to be improving, it is a recovery from very depressed levels. Why should this be the case, and does this imply anything for the characteristics and strength of any domestic recovery? The background to the depressed levels of activity in the domestic economy lies, in some part, with the very large deterioration in Japan's Terms of Trade after the second oil crisis. The decline in the Terms of Trade may be thought of as a once and for all loss of real income to the Japanese economy. There is little in the short to medium term that the Japanese authorities may attempt in order to retrieve this loss. However, overall real GNP growth may be maintained if resources are shifted away from domestic consumption and transferred to the export sector. This, broadly, is the process which has occurred in Japan over the last two years, with the initial incentive for increasing export growth provided by pronounced cyclical weakness in the yen during 1979. Chart 8 shows how the relative contributions to real growth of net exports and real private consumption expenditure have varied with the Terms of Trade in recent years. It is immediately apparent that large changes in the relative importance of net exports and consumption expenditure have been associated with large adjustments in Japan's Terms of Trade.

It is important to realise that Terms of Trade adjustments do not, primarily, reflect exchange rate movements since the Terms of Trade represents the ratio of export prices to import prices both measured in the domestic currency. Thus the decline in the Terms of Trade during 1979, and the lack of any improvement thereafter, was an important reason for the relative and absolute weakness of the domestic economy during 1980 and 1981, and hence partly why overall real growth proved vulnerable to a fall in net exports. The continued depressed levels of Japan's Terms of Trade would seem to represent an important contrast between the current period and 1978. The rise in the Terms of Trade at that time enhanced the shift towards a more buoyant domestic economy which was already occurring as a consequence of the Bank of Japan's easier monetary policy. Unless there is a rise in Japan's terms of trade in the remainder of this year, the domestic economy will not receive the additional stimulus to higher growth that it gained during 1978: the impact of reduced net exports on overall real growth may not be ameliorated by an improvement in the terms of trade "releasing" more resources to the domestic sectors of the economy.

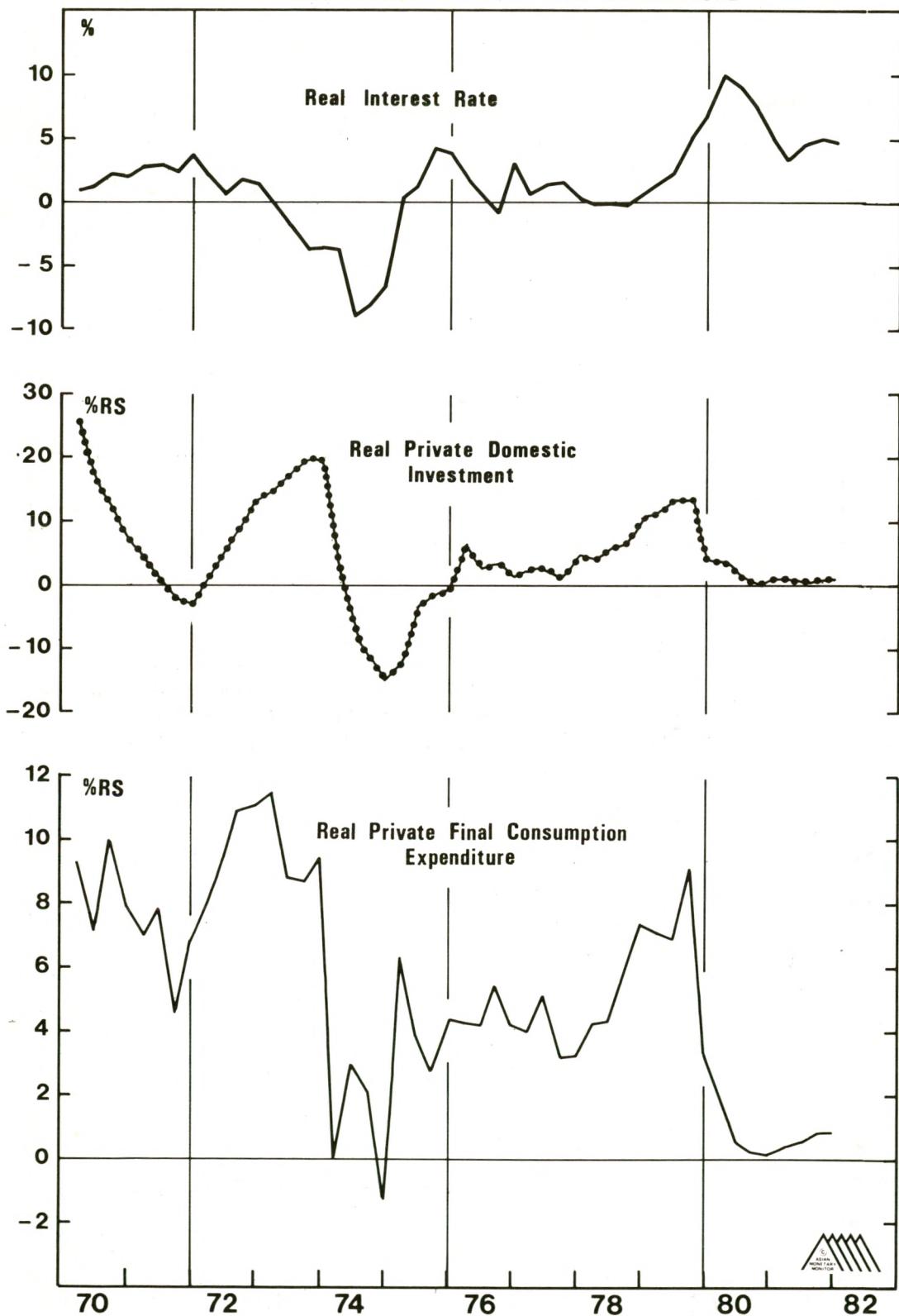
A second contrast between the Japanese economy now and in 1978 is the level of real interest rates. Chart 9 illustrates the trend in three month Gensaki rates adjusted for changes in the GDP deflator relative to real private domestic investment and consumption expenditure. It is apparent that real interest rates in Japan are currently significantly higher than at the start of the domestic recovery in 1978. Real interest rates have also declined during the present cycle, especially during 1980 when short term real interest rates plunged from over 10% to 4%. Nevertheless, real rates started to rise again during the first half of 1981 - well in advance of any noticeable

JAPAN

CHART 8: THE TERMS OF TRADE AND THE RELATIVE CONTRIBUTION TO REAL GROWTH OF PRIVATE CONSUMPTION EXPENDITURE AND NET EXPORTS



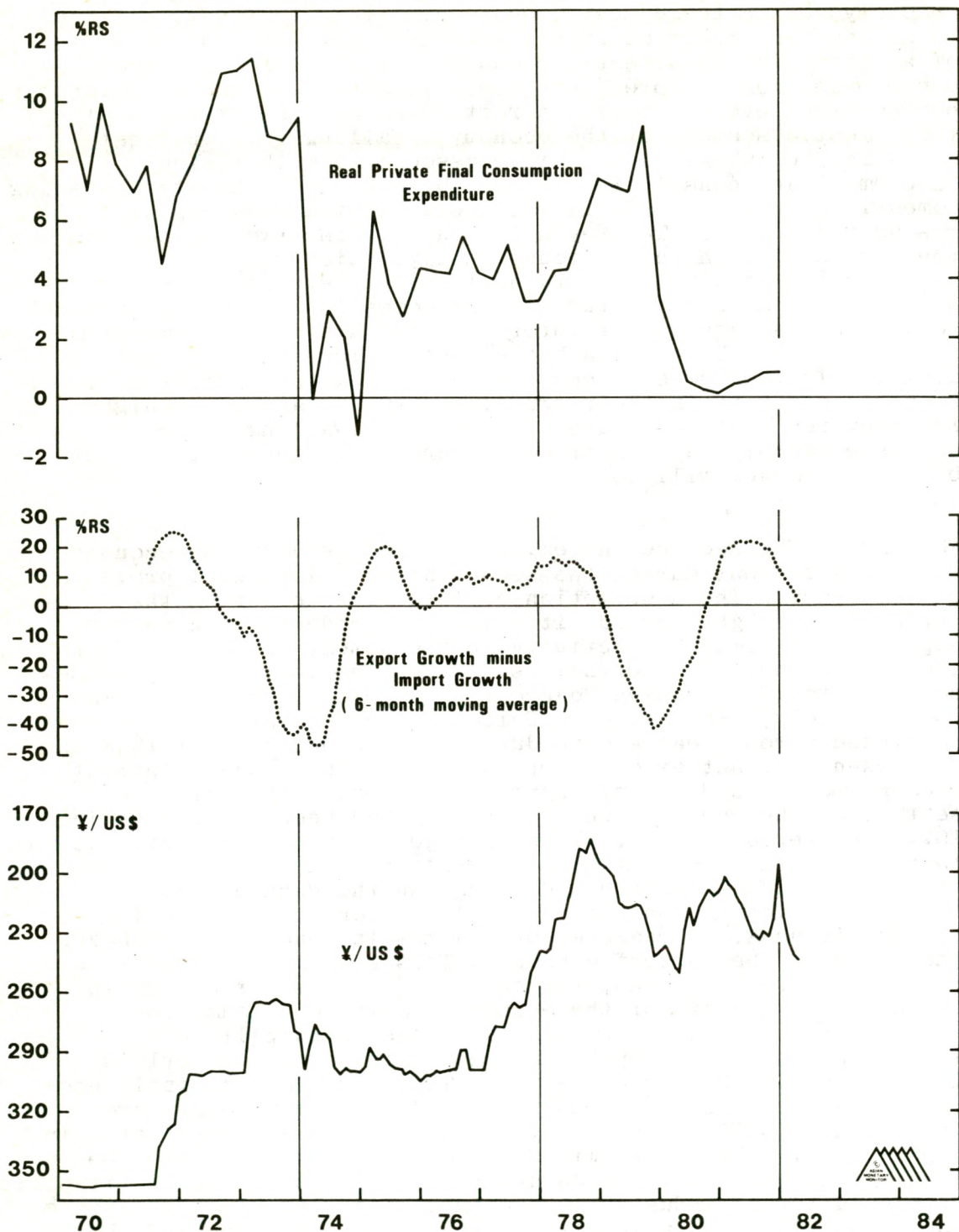
JAPAN
CHART 9 : REAL INTEREST RATES, REAL INVESTMENT AND
REAL PRIVATE CONSUMPTION EXPENDITURE



recovery within the domestic economy. It is, however, difficult to assess the impact of higher real interest rates on the level of activity in the domestic economy. It is clear from past experience, for example, that there is no one-to-one relationship between the level of real interest rates and the strength of the domestic sectors of the economy. Falling real interest rates in the 1971-73 period were associated with rising investment and consumption whilst, by contrast, the strengthening domestic economy in 1979 took place against a backdrop of rising real rates. The key difference in the two periods was the rate of growth in the money supply, which was very accommodative in 1972 and gradually more restrictive during 1979 - leading to a downturn in the domestic economy later that year. This suggests that interest rates are more a symptom of the interaction between Bank of Japan policy and the level of activity in the domestic economy than a leading indicator of economic activity in their own right. On balance, the higher level of real interest rates currently prevailing in the Japanese economy may hinder a recovery in the domestic sectors, but their impact will not be severe.

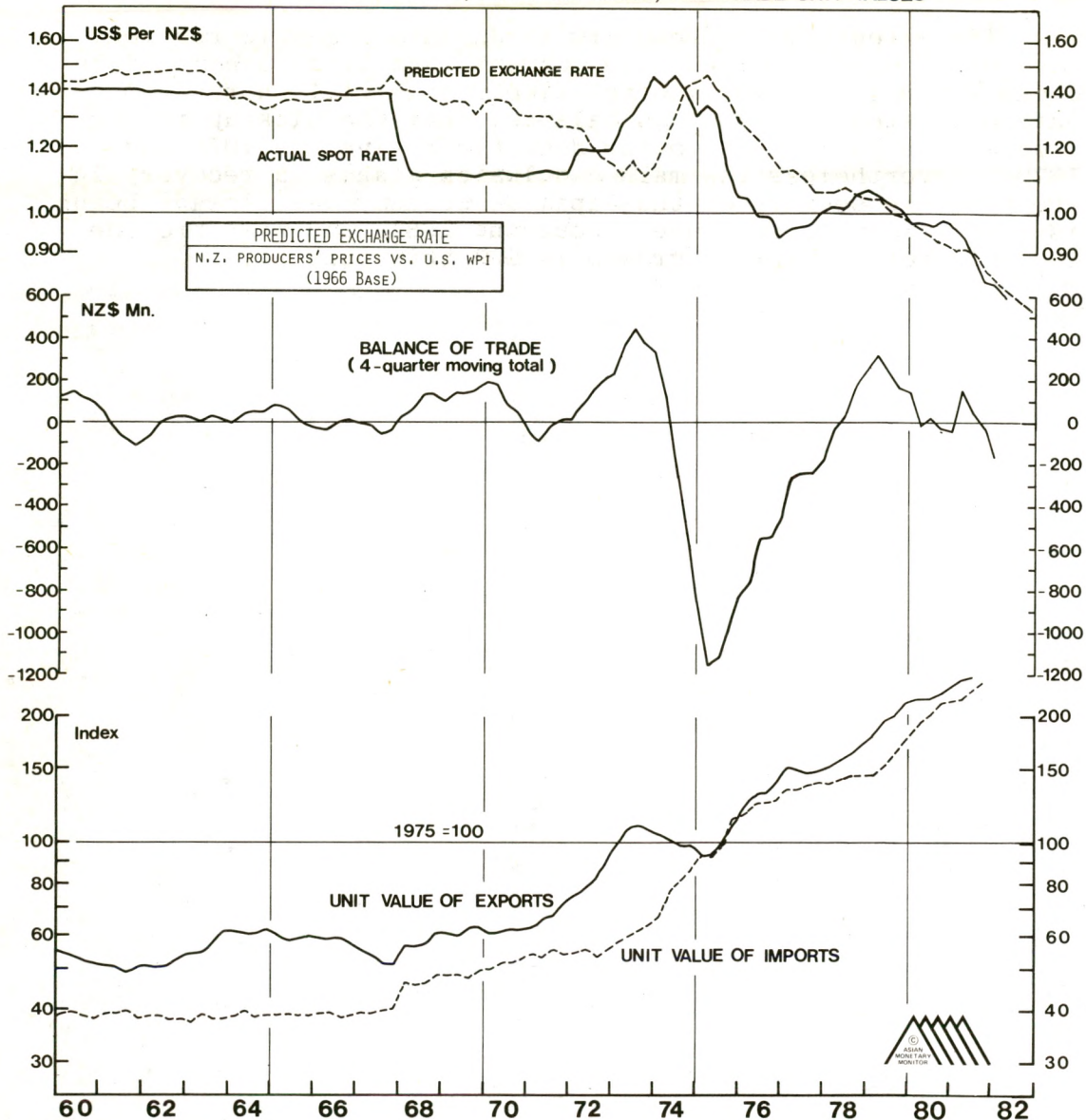
FORECAST: The decline in real growth in the Japanese economy which was evident during the second half of 1982 will prove to be temporary. The description of lower growth during that period is straightforward: it reflects a reduction in net exports at a time when activity in the domestic sectors of the economy was weak. Nevertheless the decline in net exports does not, in itself, represent cause for concern. Growth in Japan is not solely 'export-led'. Evidence for this arises from the continued strong real growth during the second half of 1978 and 1979 when real net exports were declining and Japan's current account moved to deficit. During that period the domestic sectors of the economy, where activity had been subdued during 1977, recovered rapidly. These changes in sectoral contribution to real growth are cyclical. They occur as a consequence of the interaction between broad swings in the Bank of Japan's monetary policy and shifts in Japanese economy's external competitiveness, as measured by changes in monetary growth and the trend in the current account. Thus whilst net exports have declined there is already tangible evidence of a recovery in the domestic sectors of the economy. Private consumption expenditure has started to rise and this trend will be sustained, encouraged by higher real wages and an underlying improvement in the labour market. These fundamental influences reflect easier liquidity in the form of higher monetary growth and a reduction in both inflation and nominal interest rates in Japan. Easier liquidity will also continue to stimulate the industrial sectors of the Japanese economy, where the profitability of manufacturing industry is now improving, largely in response to a stabilisation in levels of capacity utilisation and the signs of an incipient cyclical upturn in labour productivity. Industrial production has been maintained at relatively subdued levels during the past six months but, providing our analysis is broadly correct, this will prove to be a temporary slowdown.

JAPAN : CHART 10
THE YEN RATE, TREND IN THE TRADE BALANCE AND REAL CONSUMPTION



The extent of the recovery in Japan's domestic recovery is more difficult to gauge. The current lack of a turnaround in Japan's Terms of Trade and relatively high real short term interest rates suggests, on balance, that the pick-up may be moderate in comparison to the domestic revival in 1978 and 1979. Nevertheless the main conclusion stands: a recovery in the domestic sectors of the Japanese economy has already begun, is very likely to continue throughout 1982, and will provide the main source of real growth in GDP this year.

NEW ZEALAND
 CHART 1 : EXCHANGE RATE, EXTERNAL TRADE, AND TRADE UNIT VALUES



NEW ZEALAND

EXCESS MONEY GROWTH SPELLS CURRENCY WEAKNESS

The NZ\$ is a managed currency in the sense that the Reserve Bank of New Zealand fixes its value against other currencies on a day-to-day basis. The actual system of management, introduced with the 1979 budget, is that the NZ\$ is adjusted against a basket of other currencies - the principal ones being the US\$, sterling, yen, A\$ and DM, i.e. the currencies of New Zealand's main trading partners. The Reserve Bank and the Finance Ministry operate a kind of crawling peg based on the idea of a real effective exchange rate. The formula is not disclosed, but essentially involves computing New Zealand's relative inflation rate, comparing the actual past and probable future increases in domestic prices and production costs with corresponding trends in trading partner countries, and adjusting the spot value of the currency to shifts in the index number (a sort of trade-weighted index) thrown up by the formula.

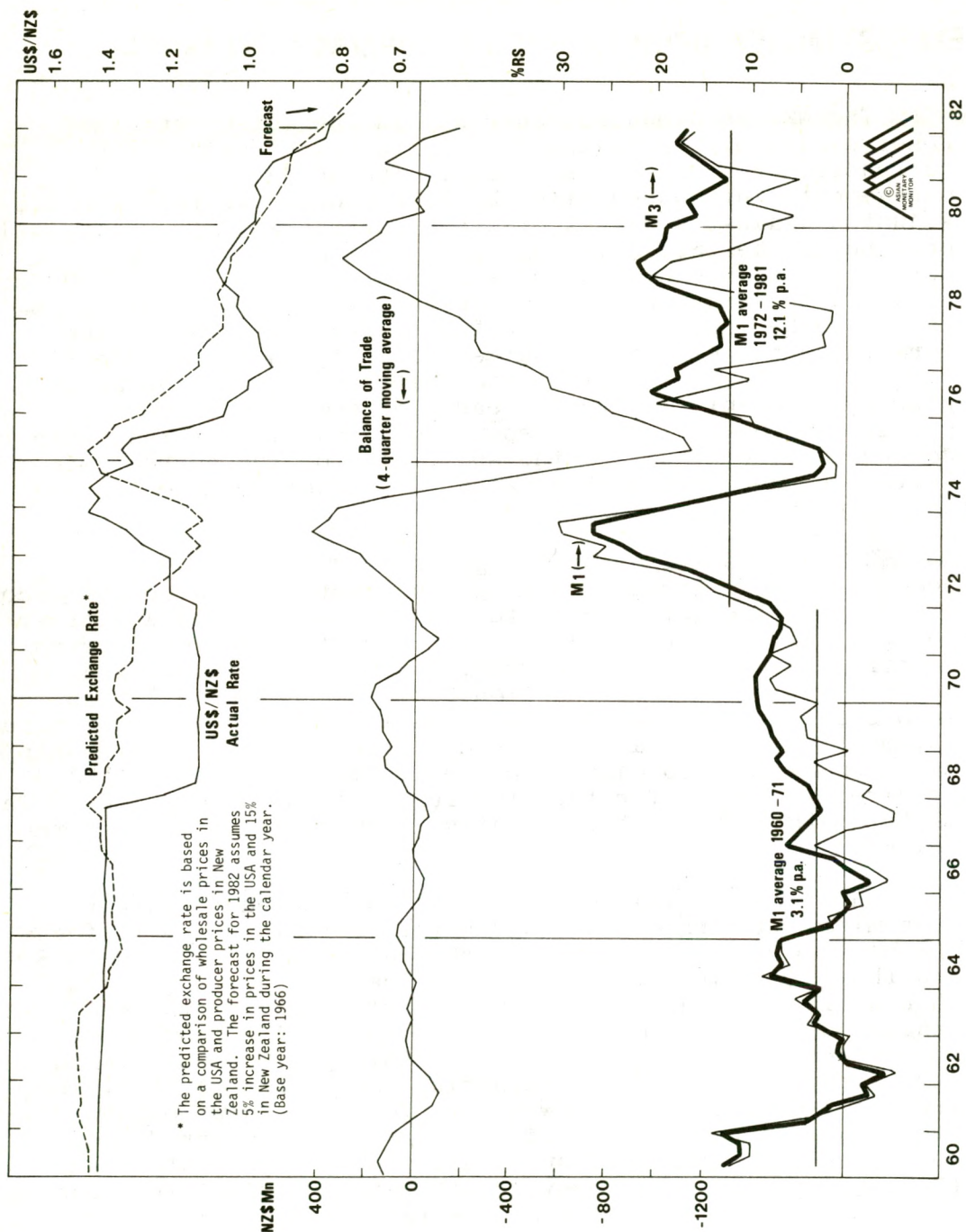
Given this system of management, theoretically all one needs to make a foreign exchange forecast is an accurate record of the relative inflation rates in New Zealand and any other country, and reasonably good forecasts of inflation in each country in the forthcoming year. From this data one can compute an approximate relationship between the inflation rates in one or more of New Zealand's trading partners and the actual movement of the exchange rates concerned. This relationship may then be used to calculate the implied value of the NZ\$ required to adjust for the difference in inflation rates. This is the methodology used in Charts 1 and 2, as applied to the US dollar.

This type of analysis could be duplicated for other economies and currencies, but in this article we shall focus on the history of and outlook for the relation between the NZ\$ and the US dollar. The most significant point to be made, though, is that the poor relative performance of the New Zealand dollar in recent years stems primarily from a persistently lax domestic monetary policy. To put this in perspective it is worthwhile noting (see Chart 2) that from 1960 to 1971 the money growth rate for M1 in New Zealand averaged 3.1% per annum, while the growth rate for M3 was 5.1% per annum (at compound annual rates). For the next decade (1971-81) the average money growth rate for M1 almost quadrupled to 12.1% p.a. while the M3 growth rate more than trebled to 18.6% p.a. This is the root of the New Zealand dollar's weakness.

When the pound sterling was devalued against the US\$ in 1967 the New Zealand currency was devalued in sympathy because it was a member of the Sterling Area despite the fact that inflation and prices in New Zealand were very much in line with prices in the U.S.A. The undervaluation of the NZ\$ due to the sterling devaluation soon produced a growing balance of trade

NEW ZEALAND

CHART 2 : MONEY, TRADE AND THE EXCHANGE RATE



surplus (see Chart 1), but the overall balance of payments surplus touched off a sustained acceleration in money growth starting in late 1967 and extending though to the end of 1970. Along with other countries New Zealand shared in the 1972-73 experience of widening trade surpluses and an appreciation of the currency against the US\$, only to see that position drastically reversed in 1974-75 when the trade accounts plunged into deficit and the exchange rate depreciated by over 35% from its peak of US\$1.46. New Zealand's currency weakness extended into 1976, but with generalised US dollar weakness again in 1977-78 the NZ\$ appreciated some 15% from US\$0.935 in late 1976 to US\$1.075 in late 1978.

If we compare inflation in the United States and New Zealand in the post oil crisis period, inflation in New Zealand has been consistently higher than price increases or cost push pressures in America in every year since 1975. Consequently calculating the "appropriate" exchange rate for the NZ\$ against the US\$ over that period has regularly produced a forecast for a depreciation in the NZ\$. This forecast has been correct in five years out of seven: the only years in which the NZ\$ actually appreciated against the US\$ were 1977 and 1978. These were also years in which New Zealand's trade balance swung dramatically from huge deficits in 1974-76 to sizeable surpluses, which suggests that while the relative inflation measure may provide a good guide to the longer term trend of the currency, such forecasts need to be modified in the shorter term by reference to the state of New Zealand's business cycle relative to the rest of the world and the related behaviour of her trade account.

In the past year or so this divergence between the state of New Zealand's business cycle and the trend of economic activity elsewhere has been particularly important because of the expansionary stance of monetary policy during 1981. M1 accelerated from 11.6% (year-to-year) in January to 16.0% by December. M3 also accelerated from 12.6% growth in January to 18.1% by October, slowing slightly to 16.7% in December. The economy also grew very strongly at close to 4% in real terms. The continuation of this strong economic growth at home at a time when most other OECD countries have been experiencing either a slowdown or an actual downturn in activity has sucked in imports while exports have slowed. The external position has therefore deteriorated over the past twelve months and this has tended to put additional downward pressure on the exchange rate and bring it back into line with the predicted exchange rate derived from relative inflation rates.

Until there is a definite slowdown in domestic activity there will be no assistance to the exchange rate from the trade balance. Equally, on a longer term basis until there is a deliberate effort to curtail monetary growth the NZ\$ must continue to be vulnerable to persistent depreciation. Although some attempts have been made to tighten monetary growth, these have never been either sufficiently determined or sufficiently sustained to have any prolonged impact on inflation. At around 16% p.a. New Zealand now has one of the highest inflation rates among OECD countries, and last year's acceleration in money growth will have done nothing to narrow the gap between

New Zealand and her trading partners, particularly as most countries were pursuing contractionary rather than expansionary monetary policies and can therefore expect lower inflation rates in 1982 than in 1981.

Assuming no improvement on New Zealand's trade account during the present calendar year, and taking into account a widening inflation differential between the U.S.A. and New Zealand as American inflation slows more decisively than New Zealand's, it is realistic to expect a depreciation of the NZ\$ against the US\$ of at least 10% for the year as a whole. (In the period Dec. 1981-April 1982 the NZ\$ has already depreciated 6%.)

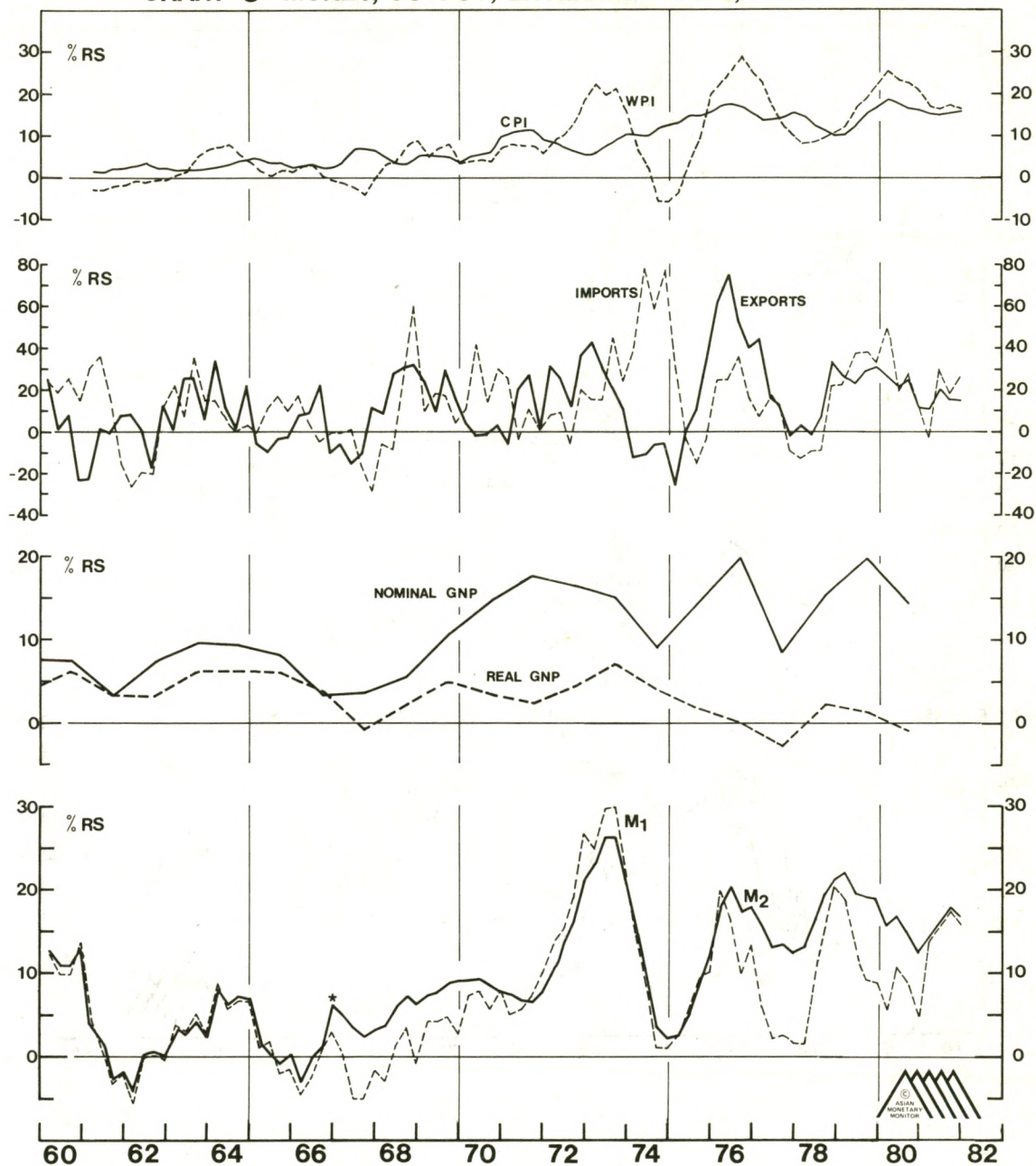
A question which is frequently debated in New Zealand and elsewhere is whether there should be an outright devaluation or whether the currency should continue to be managed steadily downwards. From an analytical standpoint outright devaluation would tend to produce greater instability of domestic monetary growth because it would result in wider fluctuations in the balance of payments. This means that there is a marginal theoretical preference for continuing with the crawling peg. But irrespective of whether there is an outright devaluation or not, the crucial question is whether domestic monetary policy will be tightened up or not.

If the Yen and the DM strengthen against the US\$ and the A\$, the trade-weighted value of the NZ\$ could remain fairly stable, and New Zealand's exports would remain reasonably competitive overall. However, stability in the trade-weighted index should not necessarily be taken as a sign of a successful policy: if the NZ\$ can only hold steady against a basket of other currencies when the US dollar is weak, then any stabilisation of the US dollar will almost certainly be accompanied by a further weakening of the NZ\$.

Stability of the internal purchasing power of a currency is a sine qua non for the maintenance of a stable external purchasing power. At the present time when other economies are achieving lower rates of inflation and their currencies are supported by high interest rates it is vital that New Zealand's policy-makers also tighten up their domestic money management. It is inconceivable that 15% money growth rates can be compatible with long term price stability in an economy whose real growth rate is normally around 3% p.a. Because the New Zealand business cycle tends to lag behind other OECD countries the need for corrective actions was masked for a time by the continued strong performance of the domestic economy. Now that the need for corrective action has surfaced in the form of a widening trade deficit it cannot be long before there is either a sharp deterioration in economic performance and/or an exchange crisis. Failure to implement corrective measures will only result in further depreciation of the currency - both internal and external.

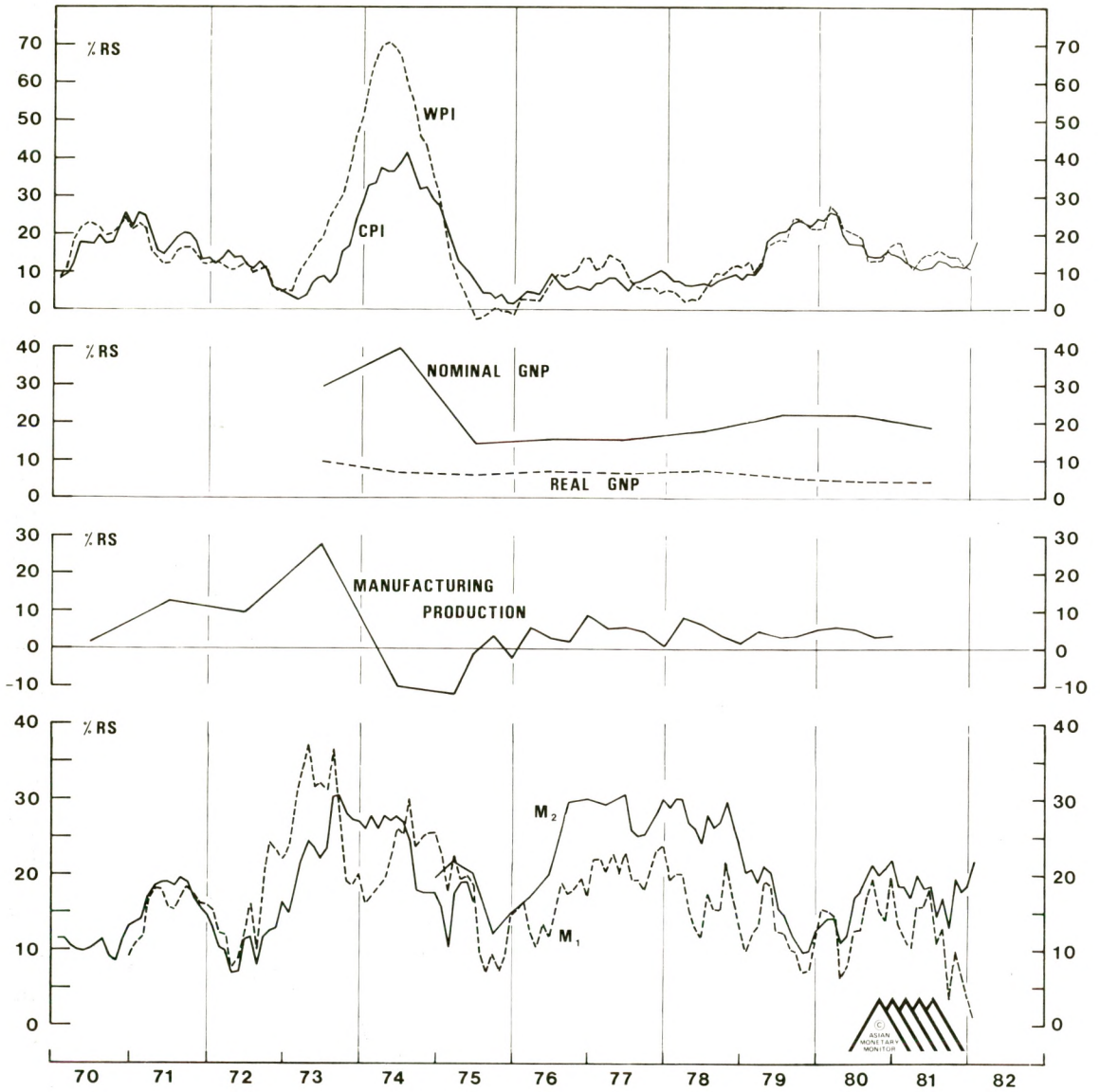
NEW ZEALAND

CHART 3: MONEY, OUTPUT, EXTERNAL TRADE, AND PRICES



* Change of data series.

CHART 1 PHILIPPINES MONEY, OUTPUT AND PRICES



PHILIPPINES

SOME IMPROVEMENT IN THE SHORTER TERM OUTLOOK

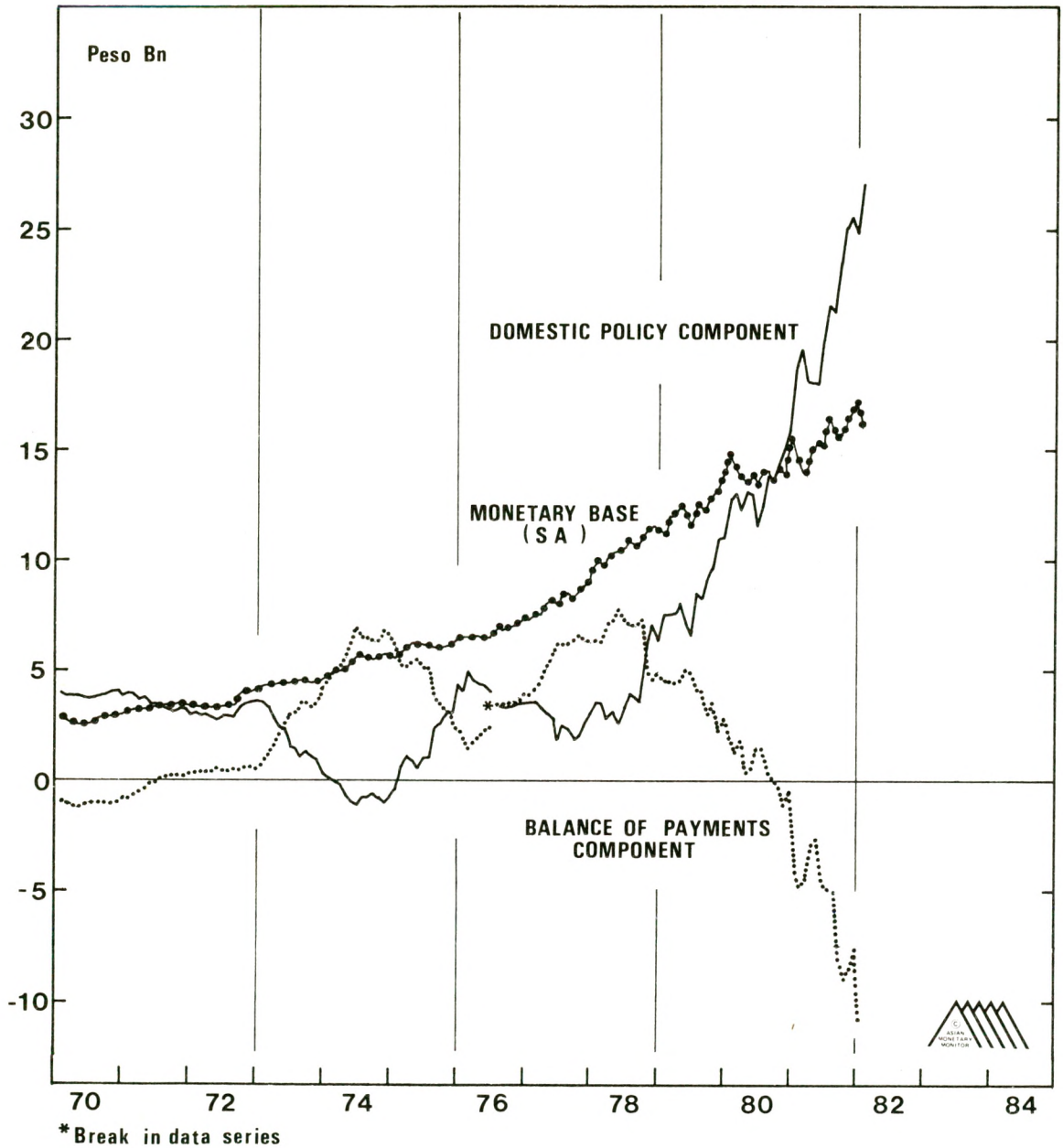
Nineteen eighty-one was a year in which the problems of the Philippine economy appeared to grow and multiply. GNP growth dropped to 4.7%, a large part of this growth being attributable to vastly increased government expenditure, and the trade deficit, as measured on a foreign exchange receipts and disbursements basis, grew to US\$2.5 bn. The Philippines' total outstanding external debt grew by over US\$3.1 bn. to US\$15.8 bn., taking the debt service ratio to 19.1%. The year began with the crisis in financial markets that followed from the disappearance of businessman Dewey Dee who absconded leaving behind US\$75 m. in debt, mostly in commercial paper. The Central Bank was quick and effective in taking measures to restore confidence (AMM Vol. 5 No. 2) but the effects of the crisis are only now beginning to recede.

One or two perhaps slightly more hopeful signs emerged from 1981. Consumer price inflation for the year fell to 12.5%, in line with the world trend, and monetary growth fell from the peaks experienced in 1980. Total liquidity growth (M2 plus deposit substitutes i.e. very short-term instruments) was, at 15.8%, close to the benchmark target of 15% while M1 growth dropped from 19.6% in 1980 to 3.5%. However, the low level of M1 growth may be partly attributable to distortions arising from the financial crisis. Also monetary growth in 1981 was largely "domestically-generated", the intention being to offset the negative impact of the overall balance of payments deficit upon the money supply.

The growth of the monetary base in 1981 can be explained by the activity of the Central Bank in increasing its extension of credit to more than offset the decline in its net foreign assets. The growth in the net domestic credits of the Central Bank in fact comprised as much as 40% of total domestic credit expansion in 1981, compared to figures of between 7% and 10% over the previous years 1977-1980. However, despite the fact that the government's cash operations deficit grew 8-fold in 1981, reaching ₱10.9 bn., due to a rapid increase in expenditures and drop in revenues, little of the domestic monetary expansion can be attributed to any increase in the Central Bank's government bond holdings, its holdings of domestic securities having grown by only ₱318 m. in 1981, compared to an increase of ₱1,026 m. in 1980. Rather, the growth in both the monetary base and the money supply can be attributed to the growth in the loans and advances component of the Central Bank's assets, reflecting the use of the 'lender of last resort' facility to aid financially distressed companies after the financial crisis.

The small increase in the Central Bank's bond holdings contrasted with the rapid growth of the commercial banks' holdings. This is partly reflective of more aggressive bond sales by the government, anxious to avoid too heavy a reliance

PHILIPPINES
CHART 2 : MONETARY BASE AND COMPONENTS



on foreign borrowings, but is more the mirror image of the cautious approach commercial banks took towards loans in 1981. Loans and discounts of commercial banks grew by 13.5% in 1981, down from 23.2% in 1980, whereas commercial banks' investments in bonds and securities grew by 17% in 1981, compared to 6.5% in the previous year. Thus, restrictions on holdings of foreign assets and their unwillingness to commit loans in the uncertain environment led to a substitution of investments for loans on the assets side of their balance sheets.

The unwillingness of banks to commit loans, particularly long-term loans, compounded the already difficult problems companies have faced in trying to obtain long-term financing in the domestic money markets. This was the problem at the root of the financial crisis. The Central Bank has taken various measures in an attempt to ease bank liquidity in order to encourage greater long-term loan commitment. These have included the liberalisation of interest rates on all deposits and loans except those under one year to maturity, where an 18% ceiling remains, and the phased reduction of reserve requirements of commercial banks. The reserve asset ratio, currently at 19%, will be reduced to 16% by the middle of 1983. In addition, reserve requirements against long-term deposits will be reduced. It is also hoped that the growth of "universal" banking will in future encourage the provision of long-term financing to companies.

However, real improvement in the health of the Philippine economy will require an improvement in the external position. The balance of trade has been deteriorating more or less consistently since the beginning of the 1970s in line with the growing uncompetitiveness of the Philippines' industry within which inefficiency has been encouraged by a barrage of import controls. One positive sign is that imports seem set to slow down this year. In 1981, import payments, as measured on a foreign exchange receipts and disbursements basis, grew by 9.5%, while export receipts declined by 4.3%. But, in considering the import bill, it is significant that non-oil import payments actually showed a decline in 1981, the whole of the increase being attributable to increased oil imports which amounted to 39% of total import payments. The increase in oil imports was due to two factors - higher oil prices and a growth in oil inventories to an abnormally high level equivalent to 130 days of consumption (compared to a norm of 90 days). Declining oil prices and some reduction in inventories (which might not be large because of the declining oil prices) this year should thus reduce the oil part of the import bill.

Chart 3 attempts to explain the growth of non-oil imports in terms of nominal GNP growth and changes in the peso exchange rate lagged by one year. Calculations based on this relationship suggest that with a nominal GNP growth of around 15% this year (4-5% GNP growth, 10-11% inflation) and after the 5% depreciation of the peso last year, the non-oil import bill should show little growth from last year's level. Then, with a decline in oil prices and some inventory reduction, total import payments should decrease in 1982. Our calculations

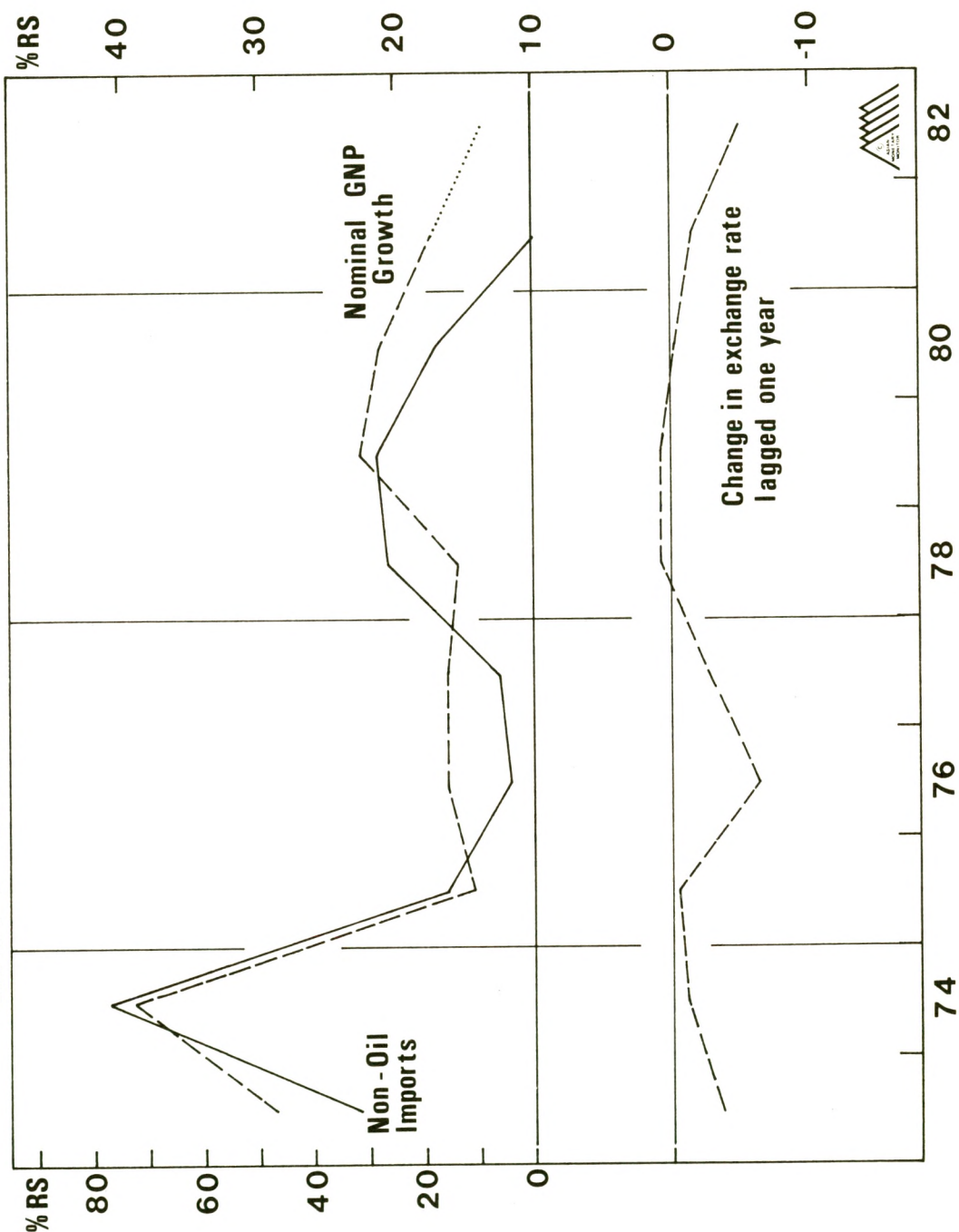
suggest that an average oil price for the year of US\$30.0 per barrel would result in roughly a 4% drop in the Philippines' import payments. This figure takes account of the effect of a reduction in price increasing oil consumption, but takes no account of inventory adjustments. Thus a reduction in inventories to the historical norm would mean a larger drop than this but a further rise in oil stock holdings e.g. to take advantage of the lower price, might reduce the immediate beneficial effect of lower oil prices. However, even if the average oil price remains unchanged from last year's level then we might still expect to see a small reduction in the Philippines' import bill.

One unknown in the import equation is the possible short-term effect upon imports of tariff reductions. However, even though the Philippines is currently in the third phase of implementation of the World Bank instigated four phase tariff reductions, from historical experience it is unlikely that tariffs will be lowered if any short-term detrimental effect for the trade balance or domestic industry emerges as a result. A minor example of this occurred recently when the Central Bank reimposed licensing on 24 items which had been amongst a list of items previously decontrolled. As it is, unfortunately, even a significant reduction in the import bill will not necessarily point to a marked improvement in the balance of trade. Export receipts last year dropped by 4.3% due to slack demand and soft prices for the Philippines' major commodity exports. Traditional exports, including copra, copper and sugar still comprise 40% of the Philippines' exports and there is little reason to expect any major recovery in the prices of these commodities in the near future, although a recovery in the economies of the major industrialised nations would certainly help to bolster Philippine exports.

An improvement in the balance of trade resulting from a decline in total trade would have at least one unfortunate consequence in that it would tend to raise the debt service ratio (i.e. interest payments on external debt as a proportion of export receipts). The ratio is currently at 19.1%, compared to the statutory limit of 20%. In an effort to keep the ratio below 20%, a ceiling has been set for new foreign borrowing in 1982 of US\$2.4 bn. This ceiling has been arrived at after a consideration of the likely trend in exports, interest rates etc. based on the view of a recovery in the US in the second half, and we feel it is slightly optimistic. Certainly any foreign borrowing in excess of this figure, which compares to US\$3.1 bn. new borrowings last year, will take the debt service ratio above the statutory limit, although this is something that will probably be tolerated.

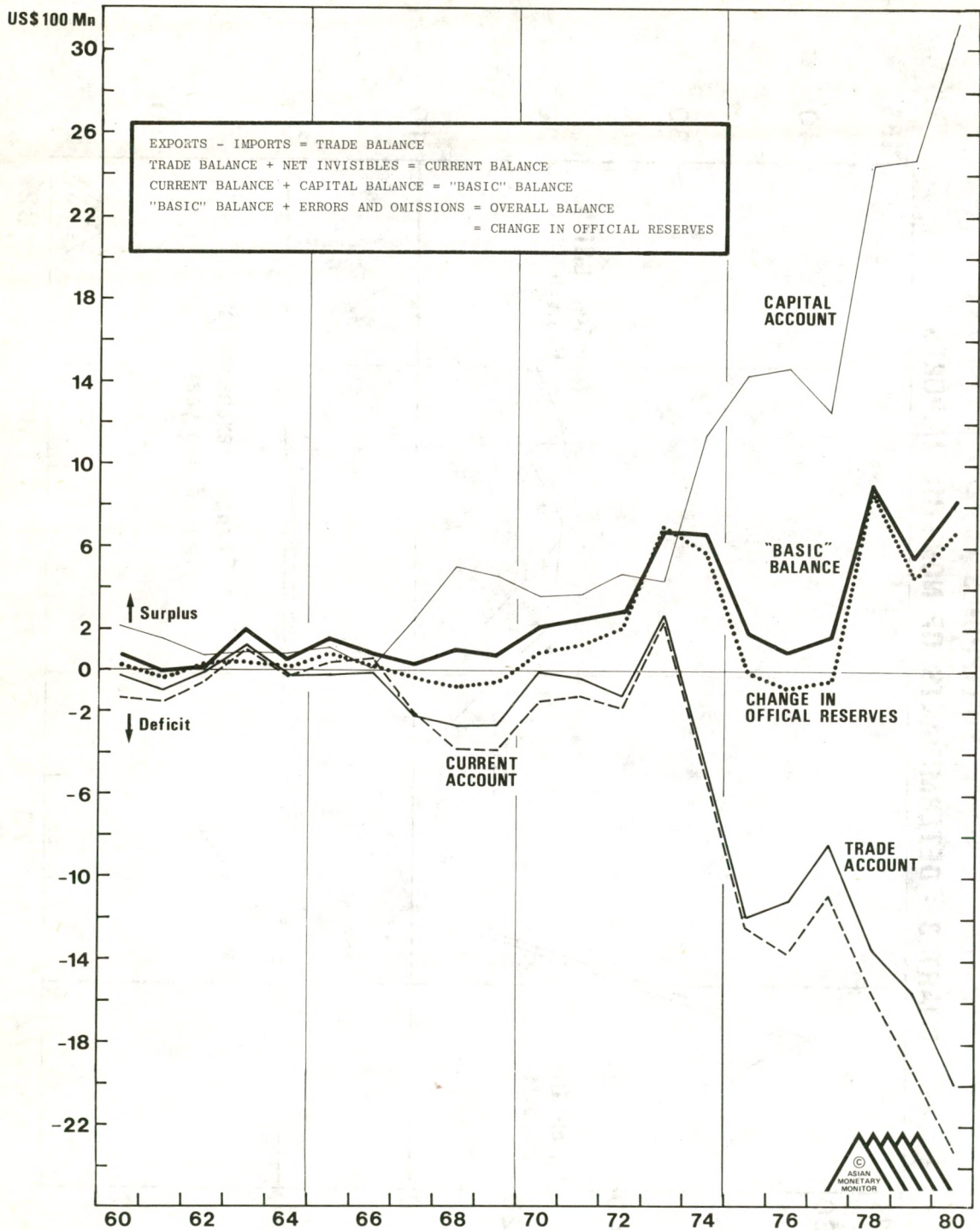
The effect of this will be to tend to some extent to divert credit demands, both public and private, back to domestic financial markets. The government's budget deficit last year rose to 3.3% of GNP, above the target long-term limit of 3% of GNP and will have to be controlled this year. Various revenue enhancing measures (i.e. the introduction of gross income taxation, improved efficiency in tax collection) have

PHILIPPINES
CHART 3 : DETERMINANTS OF NON - OIL IMPORTS



PHILIPPINES

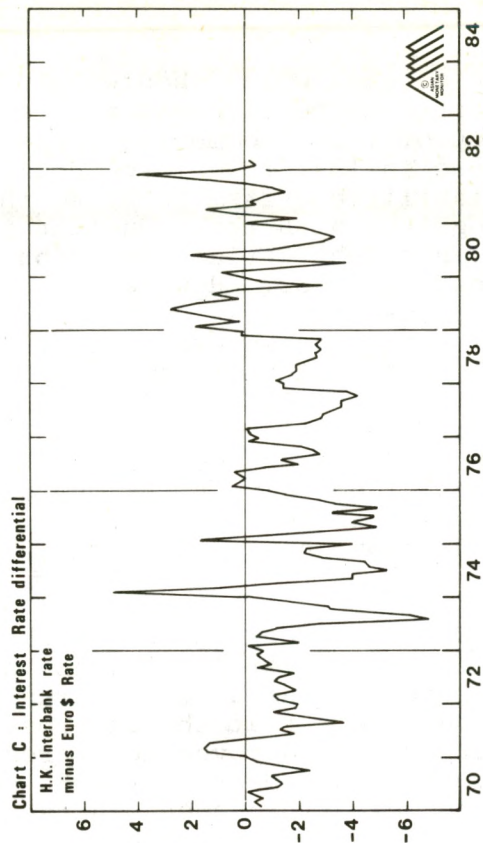
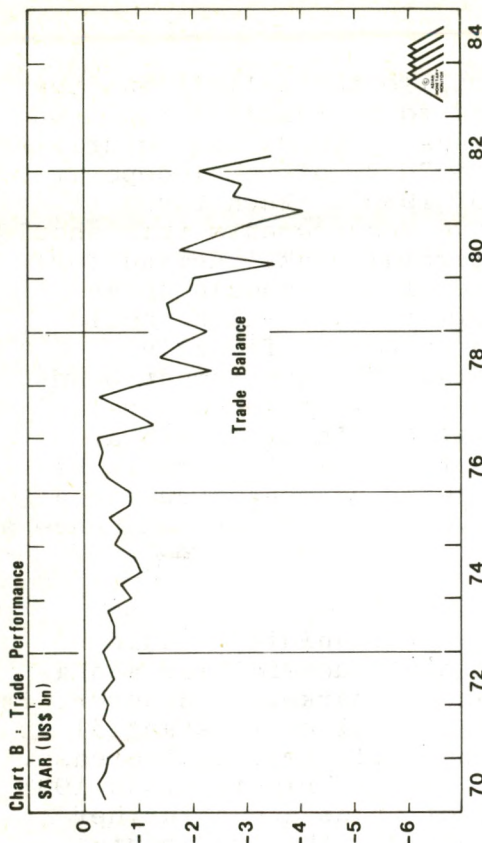
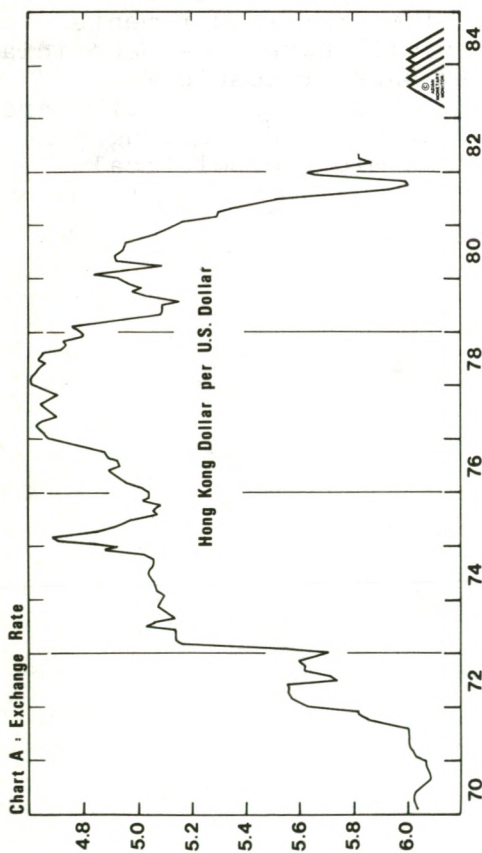
CHART 4: BALANCE OF PAYMENTS



been taken which should help to stabilise the deficit but the borrowing requirement will still tend to be fairly large. On top of this, commercial banks' holdings of bonds and securities rose in 1981 to a level equivalent to 20.2% of total deposit liabilities (from 18.5% at the end of 1980). When taken together with the reduction in reserve requirements this should mean a substantial reduction in commercial banks' demand for bonds in 1982. However, the converse of this should be an increase in banks' willingness to commit loans which should help to ease some of the pressure on corporate financing. Also, the lack of commercial bank demand for government bonds will be partly offset by increased demand from the Central Bank, who will be aiming to keep total liquidity growth at around 15% for the year in the face of what will probably be another deficit on the overall balance of payments (due to a decline in foreign borrowings relative to last year and hence a reduction in capital inflows).

FORECAST: The net result should be that liquidity should be somewhat easier in 1982 as inflation continues falling and a degree of confidence returns to financial markets. However, it is unlikely that the interest rate fall will be substantial as corporate and government credit demands will tend to increase. Overall, prospects for 1982 appear a little brighter than 1981 with some improvement in the balance of trade and a further fall in inflation to be expected. However, the fundamental problems of the Philippine economy remain and no really positive steps have been taken to address those problems. Hopes for a long-term improvement rest with 11 industrial projects and a target to supply 50% of energy requirements domestically by 1987. Although these will have some beneficial effect for the economy, and the World Bank proposals for industrial rationalisation and reduction of import tariffs are a small step in the right direction, it will take a long time to correct the results of years of economic and political mismanagement.

HONG KONG DOLLAR



Although there is good reason to remain cautious over the longer range prospects for the Hong Kong dollar, recent months have seen a cyclical reversal in its persistent weakness during 1980 and the first three quarters of 1981. During the first three months of this year the Hong Kong dollar has demonstrated relative strength against other major currencies, rising 10.3% and 5.2% against the yen and sterling respectively whilst undergoing a comparatively modest depreciation against the US dollar.

There are three underlying explanations for this cyclical turnaround in the fortunes of the HK dollar. First, Hong Kong has undergone an unexpected monetary slowdown since the spring of 1981. Second, this slower monetary growth has led to an abatement of domestic inflationary pressures. Finally, the continuation of these influences has generated an improvement in Hong Kong's underlying trade position.

The revisions to Hong Kong's monetary data during the past eighteen months preclude direct comparisons of monetary growth, but in any event it is now clear that there was a sharp contraction in the rate of growth in Hong Kong's money supply in the last half of 1981 (see Chart C). The yearly growth in M1 averaged in excess of

20% during 1979 and 1980, but M1 declined by 8% in the year to September 1981. Similarly M3 recorded a yearly increase of more than 40% between August 1980 and June 1981, but by February 1982 this rate of increase had declined to 23.7%. The authorities' most recent redefinition of Hong Kong's money supply suggests that the contraction in monetary growth may have been more pronounced. "Hong Kong dollar" M3 rose at an annualised pace of 35.2% during the first half of 1981, before declining to an annualised increase of 11.2% in the six months to February 1982. This tighter monetary policy has enabled the Hong Kong dollar to trade relatively firmly on the foreign exchanges without defensive increases in local interest rates during the first three months of 1982. Slower monetary growth has precipitated has reduced inflation in Hong Kong. Consumer prices rose by 12.4% in the year to March, down from 18% in October 1982. This improvement is reflected in Chart D, which demonstrates that in spite of falling US inflation, (US consumer price rose 6.7% in the year to March) there has been no deterioration in the Hong Kong dollar's underlying competitiveness.

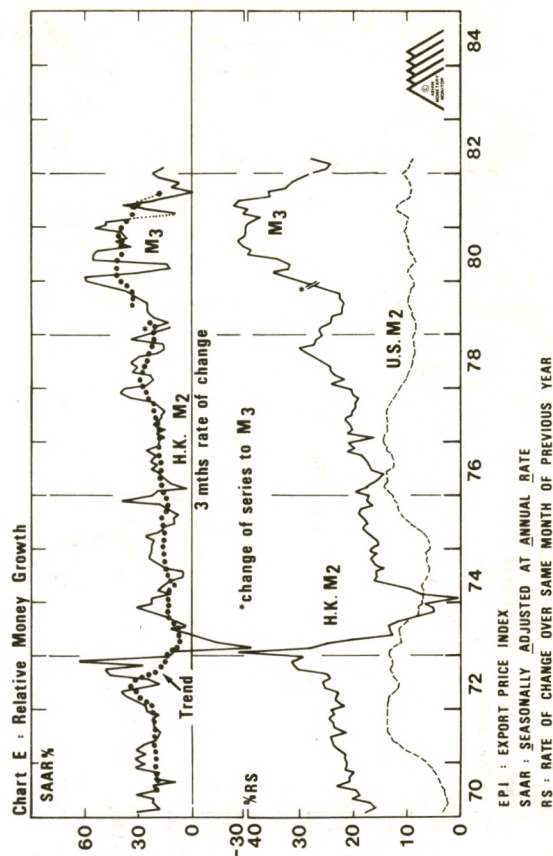
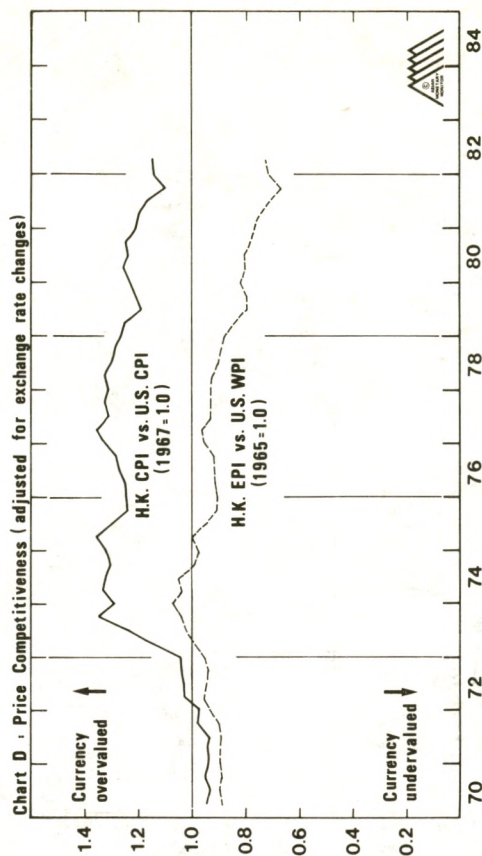
Chart B illustrates the improvement in Hong Kong's trade account evident since June 1981, which is mainly the result of falling import demand. Imports rose at a yearly rate of 8% in the three months to January 1982 in comparison to nearly 30% during the first quarter of 1981. Domestic export growth has also declined but the fall has been moderate with domestic exports rising 20%, year-to-year, in the final quarter of 1981.

Although these influences may prove bullish for the Hong Kong dollar against the US dollar, especially as U.S. rates decline, the longer term outlook for the Hong Kong dollar continues to merit caution: the authorities' present monetary policy instruments are not reliably designed to ensure longer term strength in the Hong Kong dollar.

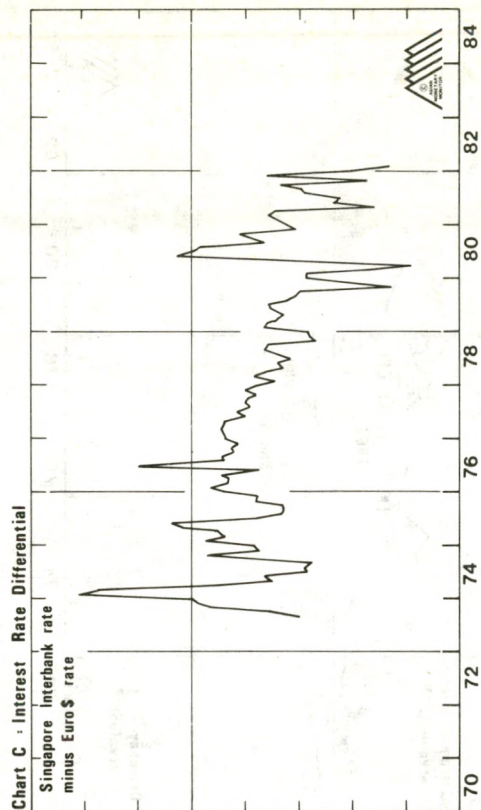
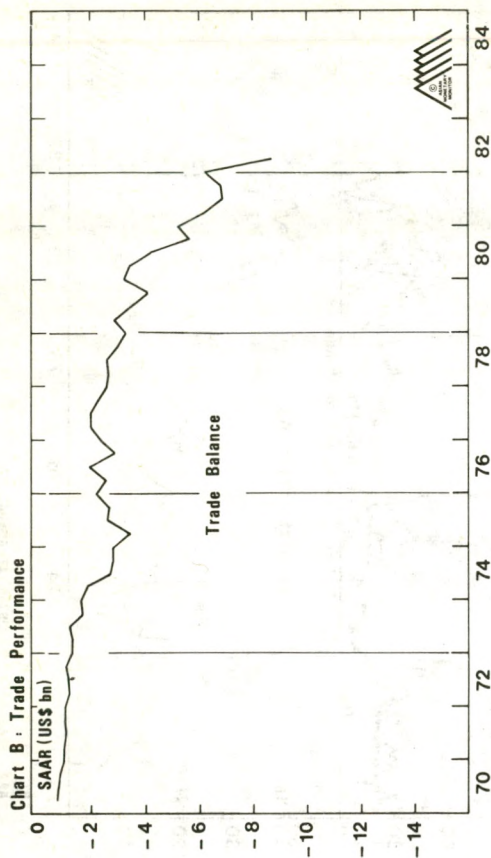
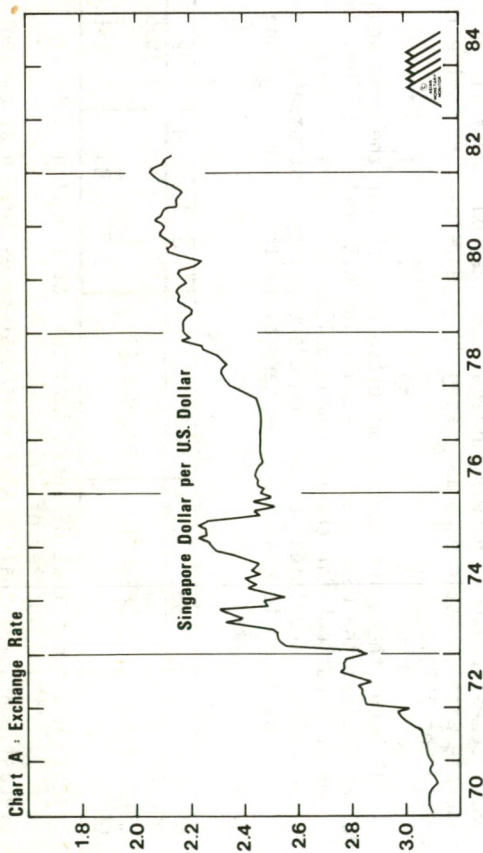
HK\$/US\$	ACTUAL		FORECAST	
	1981 Q4	1982 Q1	1982 May-Jun.	1982 Q3
FORECAST A				
Actual Range	5.568-6.148	5.688-5.923		5.40-5.60
FORECAST B				
			5.75-5.85	5.75-5.85

Forecast A assumes that US short interest rates decline into the third quarter of 1982.

Forecast B assumes that US short interest rates remain at current levels into the third quarter of 1982.



SINGAPORE DOLLAR



In our last exchange rate forecast for the Singapore dollar we pointed to the sharp drop in monetary growth that had occurred since the peaks recorded in mid-1980 and suggested that this should result in continued strength of the currency. The Singapore dollar has indeed continued generally firm although it has now retreated somewhat from the record highs achieved against the US dollar at the very end of 1981. However, although there is little likelihood of a sudden weakening of the Singapore dollar in the immediate future, the conditions necessary for continued long run strength in the currency are now no longer in place.

The main necessary condition was a continuation of the restrained monetary policy that had previously been conducted by the MAS. But in the last quarter of 1981 and first quarter of this year the MAS became increasingly concerned about the excessive strength of the Singapore dollar and the detrimental effect that this might have upon industry and the growing trade deficit. They reacted by easing liquidity to the point where interbank rates for overnight funds reached as low as 1-2% in January and February of this year. The relaxation in monetary policy over this period failed to have the desired impact upon the Singapore dollar but it did lead to a rapid acceleration in monetary growth, with the quarter-on-quarter

rate of increase of M2 for December as high as 11.0%. Inflation in Singapore has recently been dropping, wholesale prices recording actual declines when measured on a year-on-year basis and consumer price inflation down to 9.0% aided by lower rice prices, lower oil prices, lower wage increases and the strength of the exchange rate itself. However, given the recent spurt in monetary growth, the trend towards lower inflation is unlikely to continue and a situation could arise where inflation in Singapore is rising against a trend of falling world inflation. Over the last few years the Singapore dollar has tended to move fairly closely in line with its purchasing power parity (Chart D), so this would be bearish for the currency.

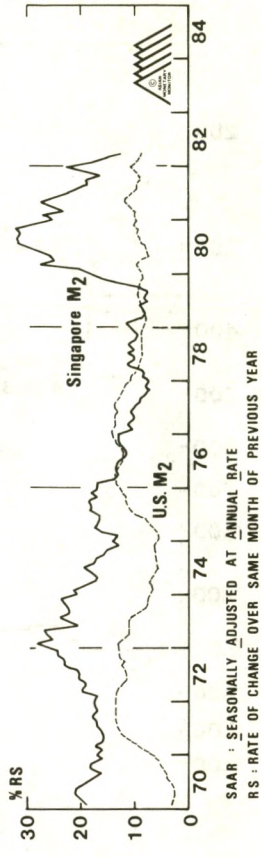
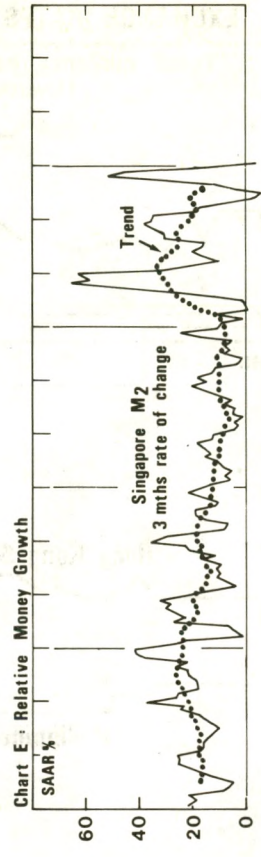
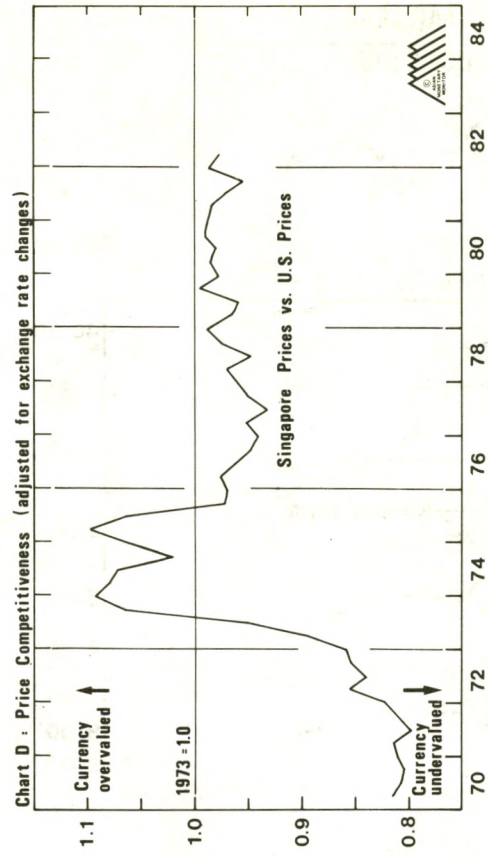
A rise in inflation is particularly likely when taken together with the relatively high level of activity expected in the domestic economy. Economic growth in 1981 was 9.9% and is expected to be around 8% in 1982. This is despite the slowdown in world trade as a result of the world recession which did not really impact upon Singapore in 1981, but will do in 1982. Growth is expected to be the result of activity in the domestic economy particularly in the construction sector. In encouraging a continued high level of import growth this will cause the trade deficit to grow beyond the US\$6.6 bn. recorded last year and prove doubly bearish for the Singapore dollar. With the world in recession it is not obvious that this expanded trade deficit will be offset by increased capital inflows and tourist expenditure as it has been in the past.

Thus, a combination of higher monetary growth, higher inflation and a growing trade deficit with a strong domestic economy but weak external sector is likely to prove bearish for the Singapore dollar in the medium term. However, the S\$ may not exhibit marked weakness against the US dollar as the US currency itself is likely to be weak in the wake of falling US interest rates. What we can say is that the Singapore dollar is unlikely to be a major beneficiary of falling US rates in the way that currencies such as the Deutschemmark and Swiss Franc can be expected to be.

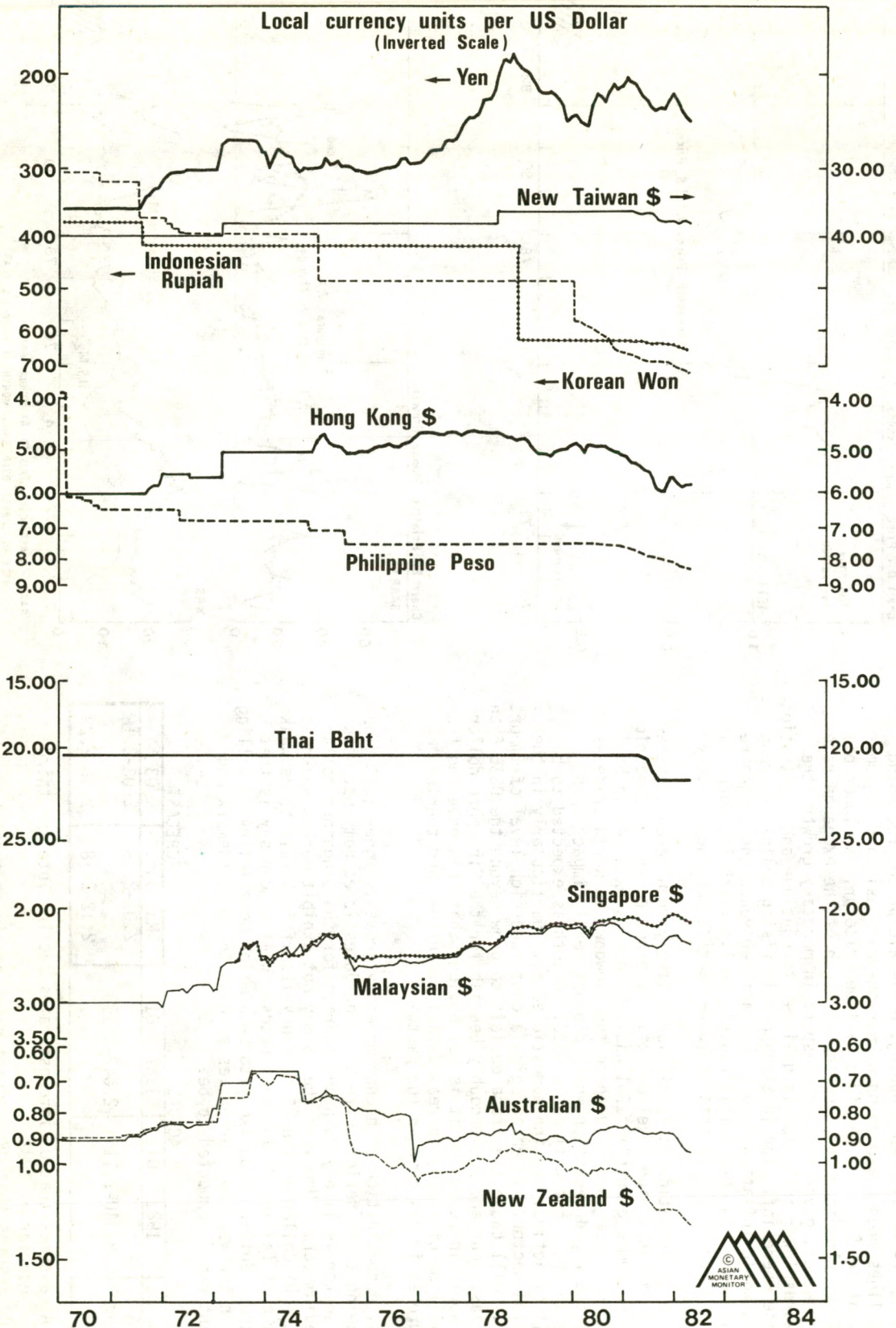
S\$/US\$	ACTUAL			FORECAST	
	1981 Q4	1982 Q1	May-Jun.	Q3	
FORECAST A			2.08-2.18	2.08-2.18	
Actual Range	2.040-2.115	2.042-2.130			
FORECAST B			2.12-2.18	2.16-2.28	

Forecast A assumes that US interest rates decline into the third quarter of 1982.

Forecast B assumes that US interest rates remain at current levels into the 3rd quarter of 1982.

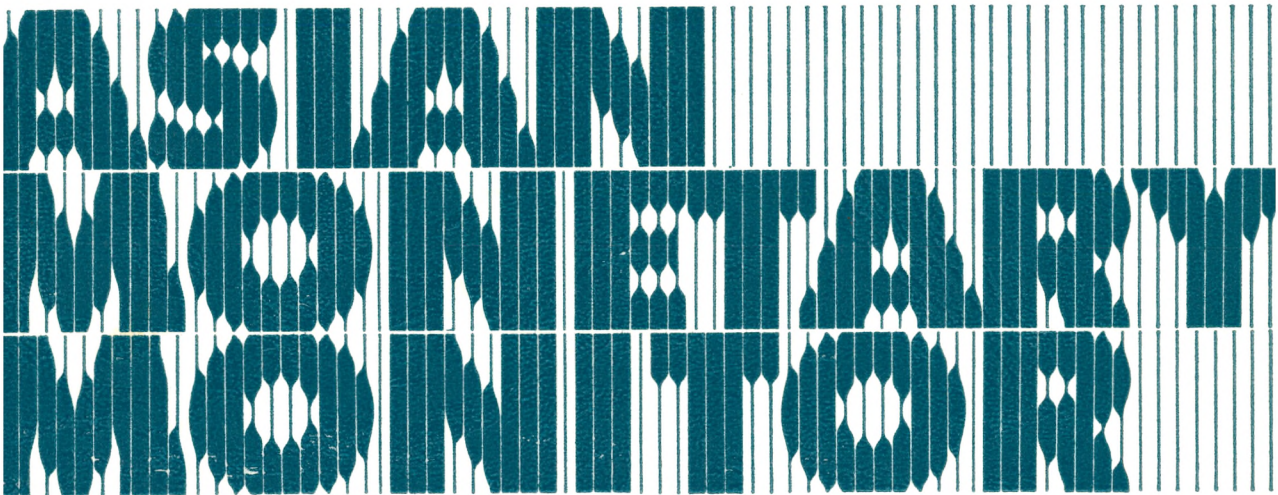


EXCHANGE RATES IN THE FAR EAST





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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

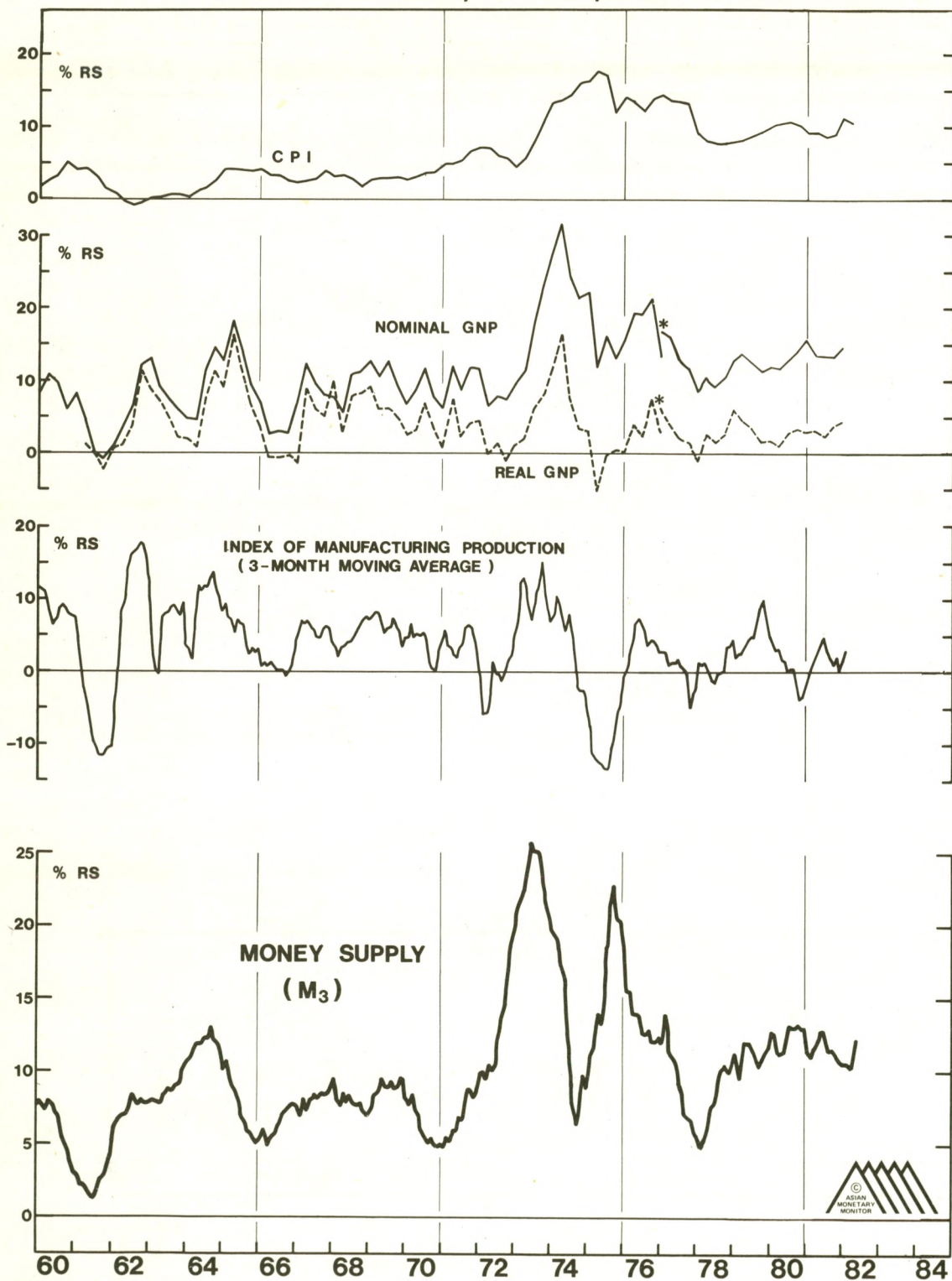
% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

AUSTRALIA

CHART 1 : MONEY, OUTPUT, AND PRICES



*Change of data series.

AUSTRALIA

RECESSION AND CURRENCY WEAKNESS

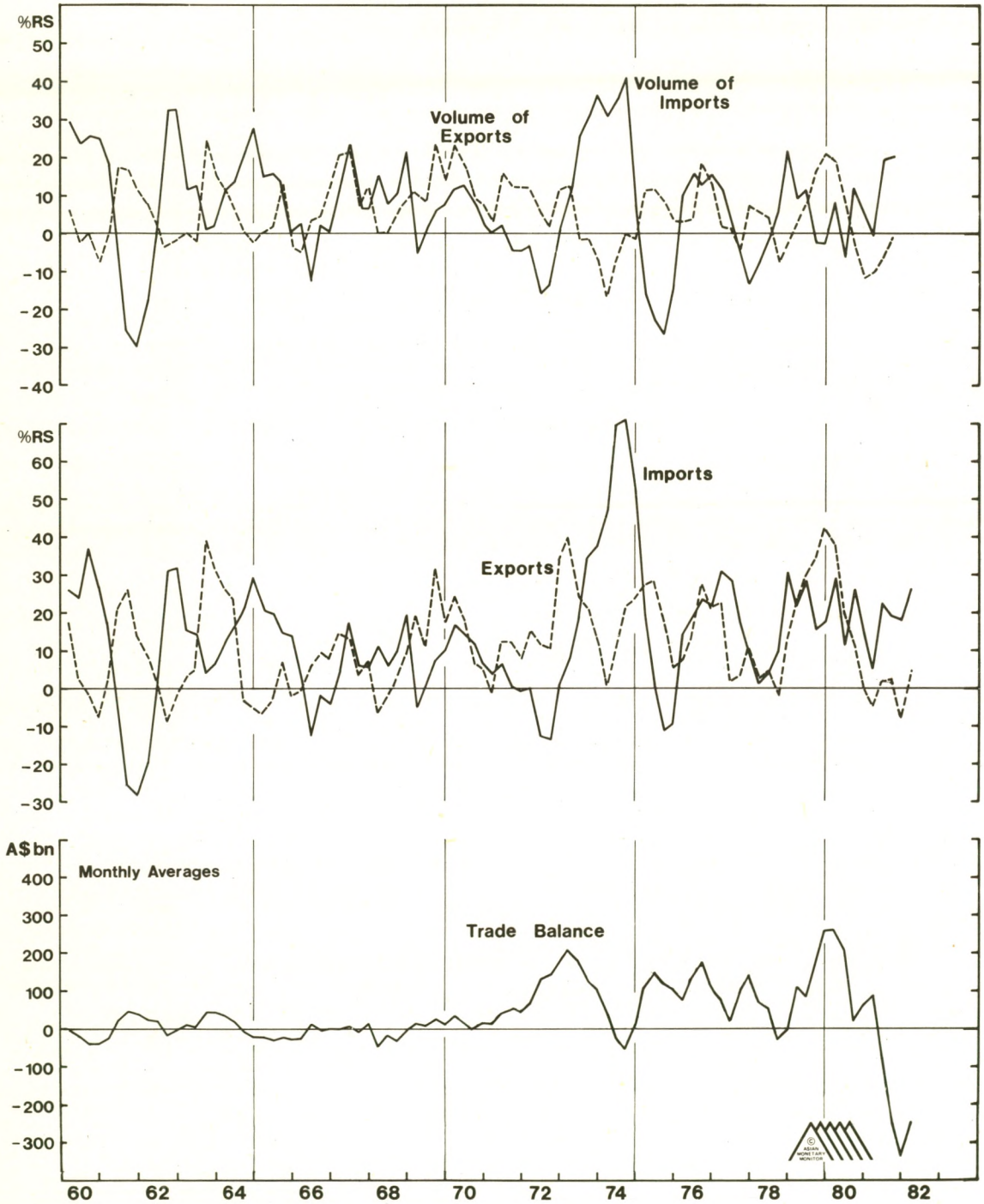
After four years of rising real growth it is likely that the Australian economy has reached a major cyclical turning point. There are basically three reasons to suggest that Australia will suffer a deterioration in its level of economic activity which will be more serious than is generally recognised. First, Australia's current account deficit is large and rising. Second, Australia's relative inflation rate is poor and likely to deteriorate. Third, and most important, Australia is likely to suffer a significant slowdown in monetary growth as a consequence of an overall balance of payments deficit. This balance of payments deficit will ultimately produce further significant weakness in the Australian dollar against all major currencies.

The forthcoming combination of a prolonged economic slowdown and currency weakness will prove that the outstanding feature of Australia's recent economic experience, namely a buoyant domestic economy in spite of a drastic deterioration in the current account is, and always has been, unstable and unsustainable.

Australia's trade and current account position has deteriorated very severely during the past two years, as is illustrated in Charts 2 and 3. Australian export growth has collapsed since the 1979 boom. In that year the total value of Australian exports rose by an average of nearly 35%. However by mid-1980, export growth had fallen to 15%, and in the final quarter of 1981 Australian exports declined by over 5% from the same period in the previous year. However the decline in Australia's export performance was not mirrored in its demand for imports. The value of Australian imports rose nearly 50% between the fourth quarter of 1979 and the fourth quarter of 1981, with import growth averaging in excess of 20% throughout 1979, 1980 and 1981.

The decline in Australia's trade account vividly illustrates how far "out of line" the Australian economy has moved in comparison with other OECD countries. The trade account has moved from a surplus of A\$2.6 billion in fiscal 1979 to a deficit of A\$2.8 billion during the last four quarters. There are two features to note in this decline. First, the deterioration primarily reflects a decline in export volumes relative to import volumes rather than a deterioration in Australia's terms of trade. During 1981 import volume growth outpaced that of exports by nearly 20% whilst Australia's terms of trade declined by a modest 2.1%. Second, the underlying trend in Australia's trade account (see Chart 4) continues to deteriorate; during the past year the value of imports rose 24% whilst exports were virtually unchanged. The implication of this trend is straightforward. Although growth in aggregate demand is likely to slow this year, this is unlikely to have any immediate impact on the broad trend in Australia's trade account.

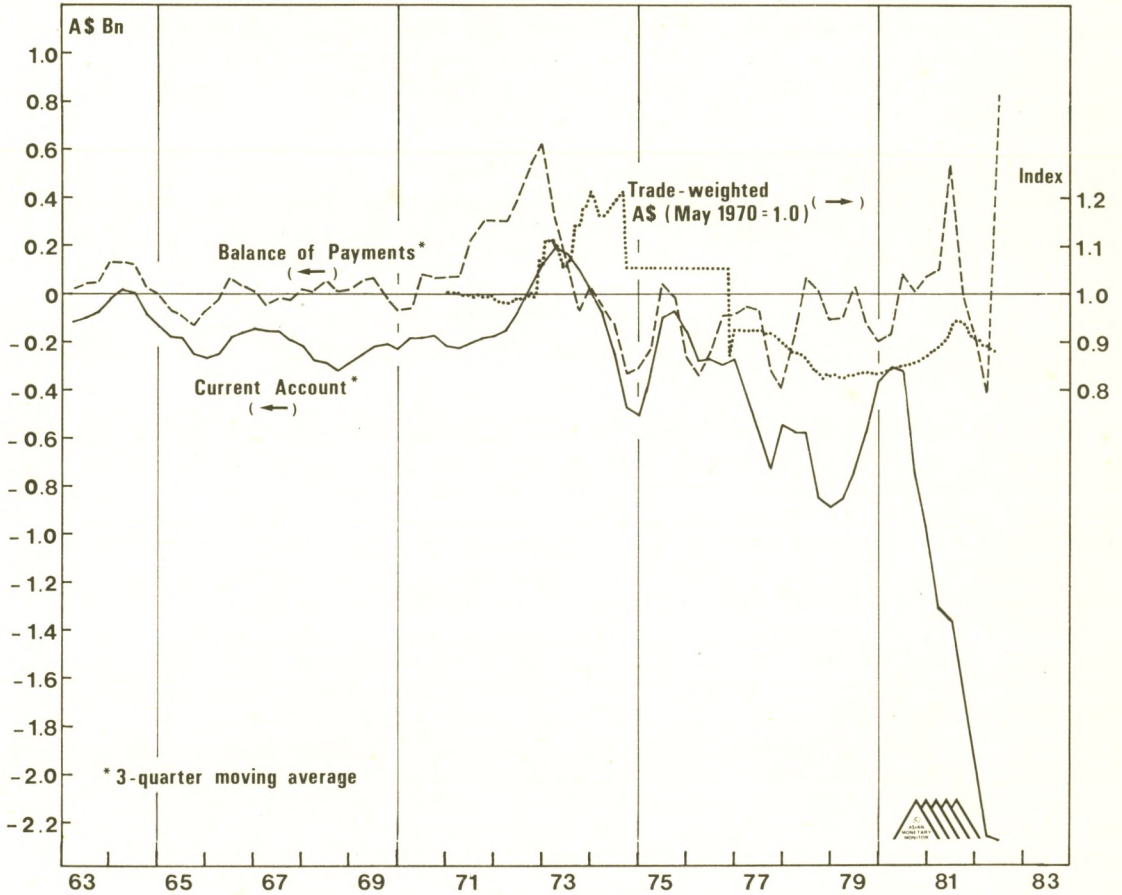
AUSTRALIA
Chart 2 : The Trade Account



AUSTRALIA

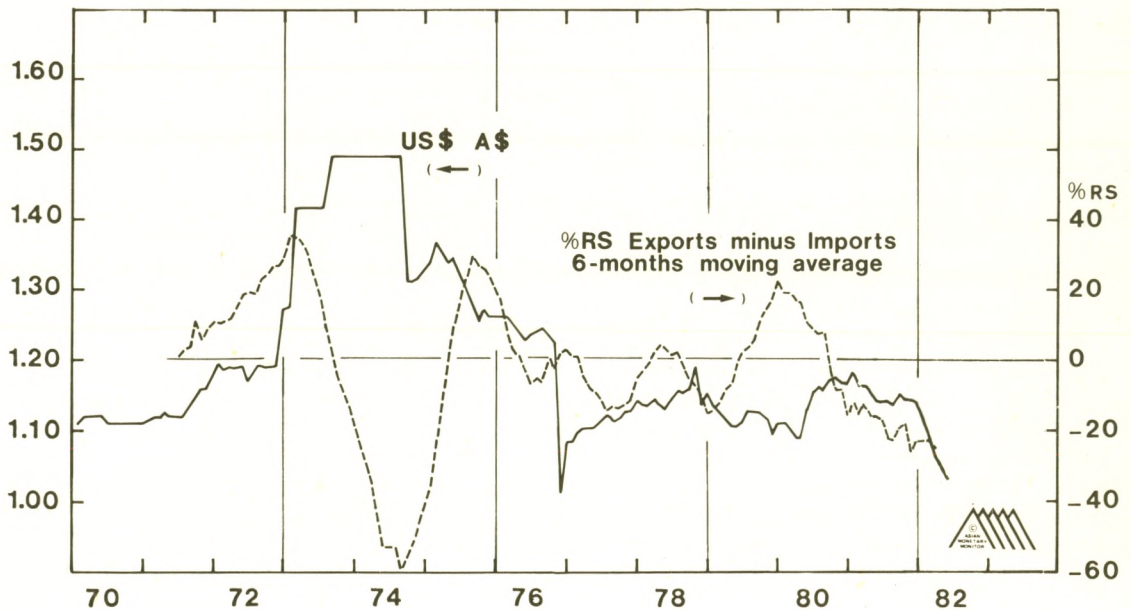
Chart 3

Current Account, Balance of Payments and Trade-weighted Value of A\$



AUSTRALIA

Chart 4 : The Trend in the Australian Trade Account



The move towards deficit in the trade account has greatly exacerbated Australia's current account deficit. In the present fiscal year (1981/82), the current deficit is likely to exceed A\$9.5 billion, or nearly 6% of nominal GNP. The current account deficit is now roughly ten times larger than during 1975 and over two and a half times greater than the previous record deficits of 1978.

It is crucial to note that the huge increase in Australia's current account deficit has not been accompanied by a sustained overall balance of payments deficit. Indeed, during the first half of 1981 Australia's balance of payments registered a near record surplus. The reason for the divergence in the two series lies with the very heavy private capital inflows reflecting direct and portfolio investment, and a favourable interest rate differential.

It is important to understand the nature of the relationship between the overall balance of payments, the current account deficit and monetary growth. It will be necessary to discuss the implications of this in more detail below. Suffice to say that in the two years up to mid-1981, this relationship evolved to produce a range of apparently favourable results: high monetary growth prolonged the economic upswing but produced greater current account deficits. Fortunately, the current deficit was more than covered by capital inflows, which enabled the Australian dollar to remain strong. However, the Reserve Bank failed to offset excessive monetary growth, thereby fuelling higher rises in nominal incomes and an even larger current account deficit, which was covered by still higher capital inflows, and so forth. The role of private capital inflows, therefore, has been to maintain monetary growth and hence the level of economic activity at a higher rate than would otherwise have occurred, whilst raising the size of the current account deficit.

Private capital inflows have helped insulate the domestic economy from the impact of the current account deficit by permitting higher monetary growth. However it is clear that this need not necessarily have occurred. The Reserve Bank could have acted to offset whatever stimulus intermittent balance of payments surpluses had on domestic monetary growth. The Reserve Bank can always offset an external stimulus to monetary growth either directly, by raising local interest rates, or indirectly through an upward adjustment to the exchange rate.

However the Reserve Bank's conduct of monetary policy has proved persistently unreliable in recent years. Growth in M3 has exceeded the Reserve Bank's target in each of the past three fiscal years. The reason for this persistent failure lay originally with the Reserve Bank's attempt to maintain interest rates at artificially low levels. Official regulation of interest rates was prevalent throughout the yield curve up until the second quarter of 1981. In early 1980, for example, the Reserve Bank misguidedly attempted to insulate the Australian economy from sharply rising interest rates in the US

by manipulating the forward discount on the Australian dollar and buying large quantities of Treasury bills. These measures - which proved only partially successful - provided the basis for excessive monetary growth later in the year. Higher monetary growth was exacerbated by the Reserve Bank's persistent efforts to price longer dated government stocks above market. As a result official sales to the non bank private sector were constantly disappointing, and monetary growth remained above target.

Since the second quarter of 1981 the Reserve Bank has sanctioned greater interest rate flexibility, especially at the shorter end of the yield curve. Regulated ceilings on bank deposit and bank loan rates have been eased, whilst Treasury Bills are now sold by tender. Nevertheless, the impact of greater interest rate flexibility on monetary control has been disappointing. M3 growth is still likely to exceed the 10%-11% fiscal 1982 target range in spite of a very substantial rise in short term rates. The immediate cause of higher M3 growth has been the overall balance of payments surplus during the past four months, which in turn reflects record private capital inflows. Nevertheless, the Reserve Bank could have offset the impact of the external account through domestic open market operations.

Reserve Bank sales of Treasury Bills would obviously have required even higher short term interest rates (three month Treasury Bill yields soared to 19% during the seasonally tight February-April period) and placed further pressure on Trading Bank liquidity. Chart 5 illustrates that, although overall liquidity in the domestic economy has been relatively easy, Trading Bank liquidity is severely restricted. Trading Banks' holdings of Liquid and Government Securities as a ratio to total deposits (the L.G.S. ratio) are currently at the lowest level ever recorded. Moreover, according to the Reserve Bank Bulletin, Major Trading Banks were unable to meet their Statutory Reserve Deposit requirements during the September-December 1981 period. Thus Reserve Bank open market sales to offset capital account inflows risked forcing Trading Banks to circumvent the L.G.S. convention if the Trading Banks had been unable to sell short term assets to the non bank public at short notice. The fundamental point remains, however, that the Reserve Bank's failure to offset the impact of capital account transactions reflects its continued reluctance to allow short term interest rates to rise to levels which would allow it to attain its stated monetary growth objectives.

Similarly, it has sometimes been asserted that the Reserve Bank utilised the exchange rate as an instrument in its anti-inflation policy. Official adjustments to the exchange rate act to influence monetary growth in an indirect fashion - through the impact of the exchange rate on the balance of payments. Once again, the persistence of above-target M3 growth in Australia implies that the Reserve Bank has been insufficiently aggressive in appreciating the Australian dollar against the trade-weighted index of currencies in order to reduce the balance of payments surplus - especially during 1980 and the first half of 1981 - and hence contain monetary growth.

An important feature to note about the combination of monetary and exchange rate policy in Australia is that - on any international comparison - both have been relatively stable during the past three to four years. The year-to-year growth in M3 has ranged between 10% and 13½% since the third quarter of 1978, whilst a trade-weighted index of the Australian dollar has traded between 82.1% and 94.4%, a 13% range. However, this uneasy relationship between internal and external economic policy seems likely to break down over the coming year.

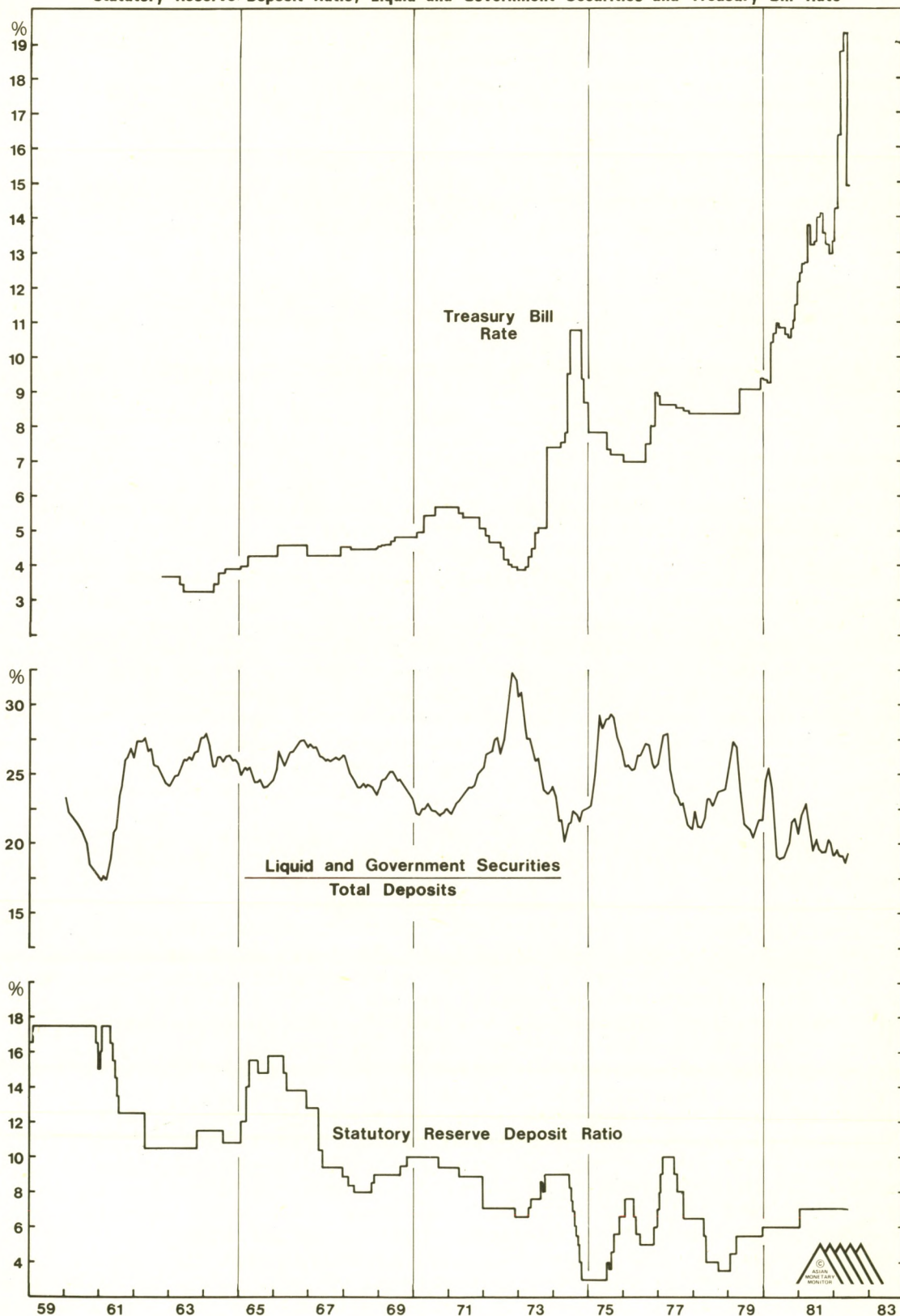
The trend in inflation and the trade account implies that the present mix of domestic and exchange rate policy is very likely to prove unsustainable. In the medium term, monetary growth can only be sustained at its present level if the Australian dollar is allowed to depreciate sufficiently to reverse the trend in the trade and current account - otherwise monetary growth will contract through an overall balance of payments deficit. Conversely, we may only reasonably expect the Australian dollar to be sustained at close to current levels if monetary growth contracts. If this fails to occur persistent current account deficits will ultimately lead - as is happening (see Chart 6) - to a drain on Australia's international reserves and a *force majeure* depreciation of the currency.

Monetary growth has already started to fall in Australia. The year-to-year growth in M3 declined from 12.8% in June 1981 to 10.3% in March 1982. M1 growth plunged from 12.0% to 5.4% over the same period. Although growth in the monetary aggregates rose quite sharply during the second quarter of the year in response to a large, temporary balance of payments surplus the underlying trend in the money supply is towards lower growth, reflecting the basic trend towards increased overall balance of payments deficits (refer to Chart 3). The combination of reduced monetary growth, continued high inflation (refer to Chart 1) and the surge in short term interest rates (refer to Chart 5) has brought the Australian economy to the initial stages of a cyclical slowdown. Unemployment has started to rise, factory production is declining (see Chart 1) and growth in real private investment has abated to between 10% and 15% as compared with the cyclical highs of nearly 25% in mid-1981.

This cyclical slowdown is likely to prove more extensive and prolonged than is generally accepted. The critical issue is the size of the current account deficit. Although the deterioration in the current account deficit is plain for all to see, its implications, apparently, are not. Over the past two years the Australian economy has moved to a position where liquidity growth in the domestic economy is dependent on large private capital inflows. It is of course entirely possible that official borrowings will be substituted for private overseas indebtedness but this would not change the fundamental picture in any important way.

An early end to the economic slowdown which Australia has recently embarked upon would typically require easier overall liquidity. (i.e. higher monetary growth and a reduction in

AUSTRALIA : CHART 5
Statutory Reserve Deposit Ratio, Liquid and Government Securities and Treasury Bill Rate



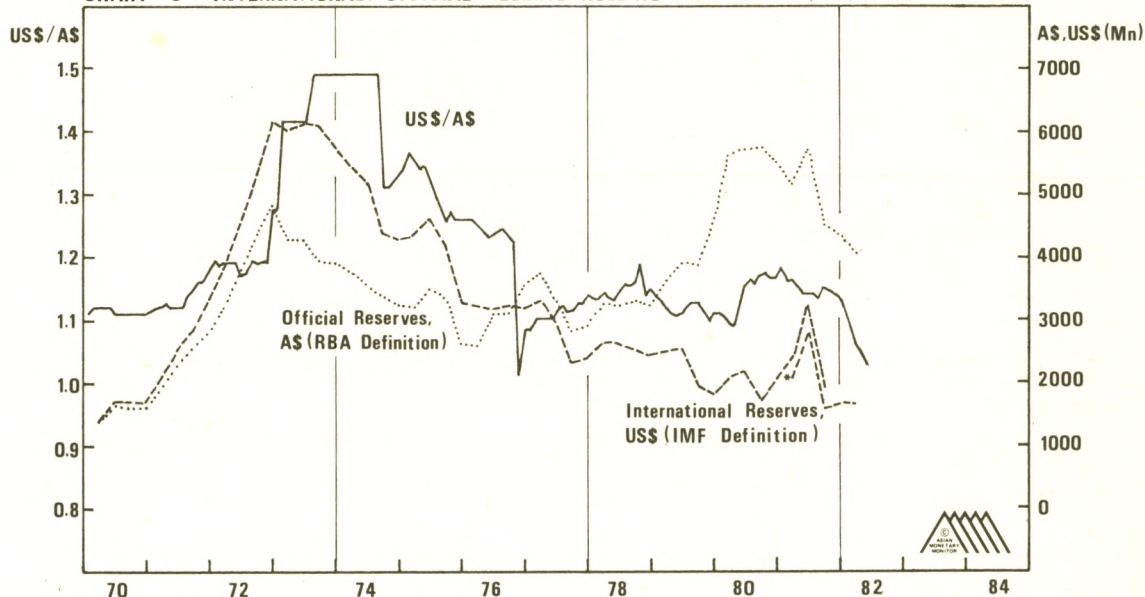
inflation and interest rates) in the domestic economy. In the past (1961, 1964, 1971, 1975, 1978) this has occurred in the wake of an improvement in Australia's trade and current account, but this need not necessarily be the case. Assume for the moment that the authorities attempt to stimulate the domestic economy from its present position. If experience in other countries in previous cycles (the U.S. in late 1972, the U.K. in 1975, France at present) is any guide, such a policy would induce capital outflows and heavy speculation against the Australian dollar. Thus any attempt to stimulate the economy is likely to prove counter-productive since the Reserve Bank would almost certainly need to finance balance of payments deficits.

Therefore, it seems, a prerequisite for a recovery in the domestic economy in Australia is a large improvement in the current account deficit. Three aspects of recent trends in Australia's trade account are important in this regard. First, as mentioned above, the underlying trend in Australia's trade account is continuing to deteriorate with export growth lagging import growth by around 20%. The gap reflects rapid growth in the volume of imports. Although this is likely to slow with the economy there is a large leeway to be made up. Second, previous business cycles suggest that Australia's trade account will not benefit from an improvement in Australia's terms of trade until well into a worldwide recovery. (Australia's terms of trade did not rise significantly until mid-1973 in the 1970-74 cycle, and not until 1979 in the 1975-1980 upturn.) Thus the argument that a recovery in Australia's trade account awaits a revival in commodity prices should be treated with caution: typically it is a recovery in export volumes that is the key to an improvement in Australia's trade account and this may well depend on the strength of the recovery overseas. Finally the "invisible" portion of Australia's current deficit is, by all accounts, in a secular decline with the deficit rising steadily from A\$300 million in 1973 to more than A\$5 billion in 1981/82.

These factors all suggest that at the current exchange rate a prolonged slowdown in the domestic economy will be necessary to bring about a sustainable improvement in the current account deficit. The longer term problem, however, is that any prolonged slowdown in the domestic economy would tend to reduce short-term interest rates in Australia. This in turn risks a reduction in capital inflows. This is what was meant by the "instability" of the relationship between capital inflows, the current deficit and monetary growth. The role of capital inflows over the last three years has been to maintain monetary and income growth at higher levels than would otherwise have been the case, and to exacerbate the current deficit. The government attempted to counteract inflationary pressures by appreciating the Australian dollar against the "basket". This process will however be terminated once - as is inevitable and is now occurring - a trend towards an overall balance of payments deficit produces an external drain on monetary growth. For then continued high interest rates and further declines in monetary growth will be necessary to stem the balance of payments deficit. The authorities' policy

AUSTRALIA

CHART 6 : INTERNATIONAL / OFFICIAL RESERVE HOLDING AND THE US\$/A\$ EXCHANGE RATE



* Excludes valuation changes in official gold holdings

decision becomes more difficult for the Australian authorities once they decide that the decline in monetary growth - and the decline in nominal income growth - has gone far enough. Any attempt to ease at that stage can only be accomplished through a depreciation of the Australian dollar.

FORECAST: The Australian economy will be beleaguered by a prolonged economic slowdown, continued high real and nominal interest rates and further currency weakness. This conclusion may appear unseemingly pessimistic. However, a comparison of the economy during the 1975/76 recovery and its present circumstances may be helpful in highlighting some of the hurdles the Australian economy must overcome in this cycle. The 1975/76 recovery occurred after a severe monetary slowdown (M3 declined from 28% year-to-year in mid 1973 to 5% by the end of 1974) and during a period of very easy liquidity: monetary growth soared once again in 1975 whilst short-term interest rates halved and inflation declined. At the same time, the trade account moved to a solid surplus - aided by a large depreciation of the Australian dollar ahead of a strong, ultimately inflationary recovery overseas.

So far in this cycle, there has been no pronounced monetary squeeze, inflation and interest rates are still high, the trade deficit is deteriorating and the Australian dollar has depreciated only 6% from its high against the trade-weighted index. At the same time, the prospects for economic recovery overseas are moderate at best.

A parallel with the West German economy in this cycle may also be instructive. The deterioration in the underlying trend of West Germany's current account during 1979 and 1980 was countered by a very aggressive monetary squeeze. The Bundesbank reduced M3 growth from a year-to-year rate of 12½% in mid-1979 to 4½% in mid-1980. This induced a recession in the domestic economy but also, in time, led to an underlying improvement in the current account deficit as the economy and import growth weakened. In the second half of 1980, when exports began to rise firmly, and with domestically generated inflation coming under control the Bundesbank decided not to intensify its monetary squeeze any further. M3 growth averaged 6% between mid-1980 and the end of 1981. In spite of this conservative monetary policy the deutschemark weakened against nearly all other major currencies up until August 1981. West Germany, which in many respects, was in a superior economic condition than Australia has now suffered, first, a monetary induced recession and then, after the monetary squeeze was marginally relaxed, severe currency weakness until an underlying improvement in the current account became evident.

This is likely to be the pattern in Australia. The deteriorating trend in the overall balance of payments will encourage a further monetary contraction which will precipitate a prolonged economic slowdown. Indeed, a period of negative real growth is feasible at some stage over the next year and a half. An overall balance of payments deficit will induce downward pressure on the Australian dollar against all major currencies. This pressure will increase as and when the Australian authorities attempt to limit the prospective decline in monetary growth. The Australian dollar is therefore likely to trade substantially below parity to the US dollar over the next eighteen months.

HONG KONG

MONETARY DOWNTURN COMPOUNDS TRADE WOES

The downturn in world trade is slowly but surely affecting the economic performance of Hong Kong. Not only is the slowdown apparent in the external sector, but it is also having a pronounced effect on domestic activity.

The performance of Hong Kong's export sector is illustrated in Chart 1 and shows that total export growth (i.e. domestic exports plus re-exports) peaked at a growth rate of between 40% and 50% in 1979 and has been slowing down ever since. In US\$ terms domestic export growth had come to a virtual standstill by mid-1981, and it was only the 20% depreciation of the Hong Kong dollar against the US\$ which kept up the appearance of a continuing export boom. But even in Hong Kong dollar terms the slowdown is now undeniable: domestic exports for May 1982 were virtually unchanged from May 1981, and imports were actually down by 3% (both figures in nominal terms). In real terms, too, the downturn has arrived: after zero growth in the first four months of the year the quantum index for domestic exports then plunged 7% in May.

In the domestic economy there is ample evidence that growth has come to a near-standstill. Retail sales have fallen, the output of cement for the local building industry fell by 7.4% in the final quarter of 1981 and by 6.7% in the first quarter of 1982. The supply of new residential premises had slowed up by the third quarter of 1981, and unfilled commercial office space rose sharply in the subsequent six months to March 1982.

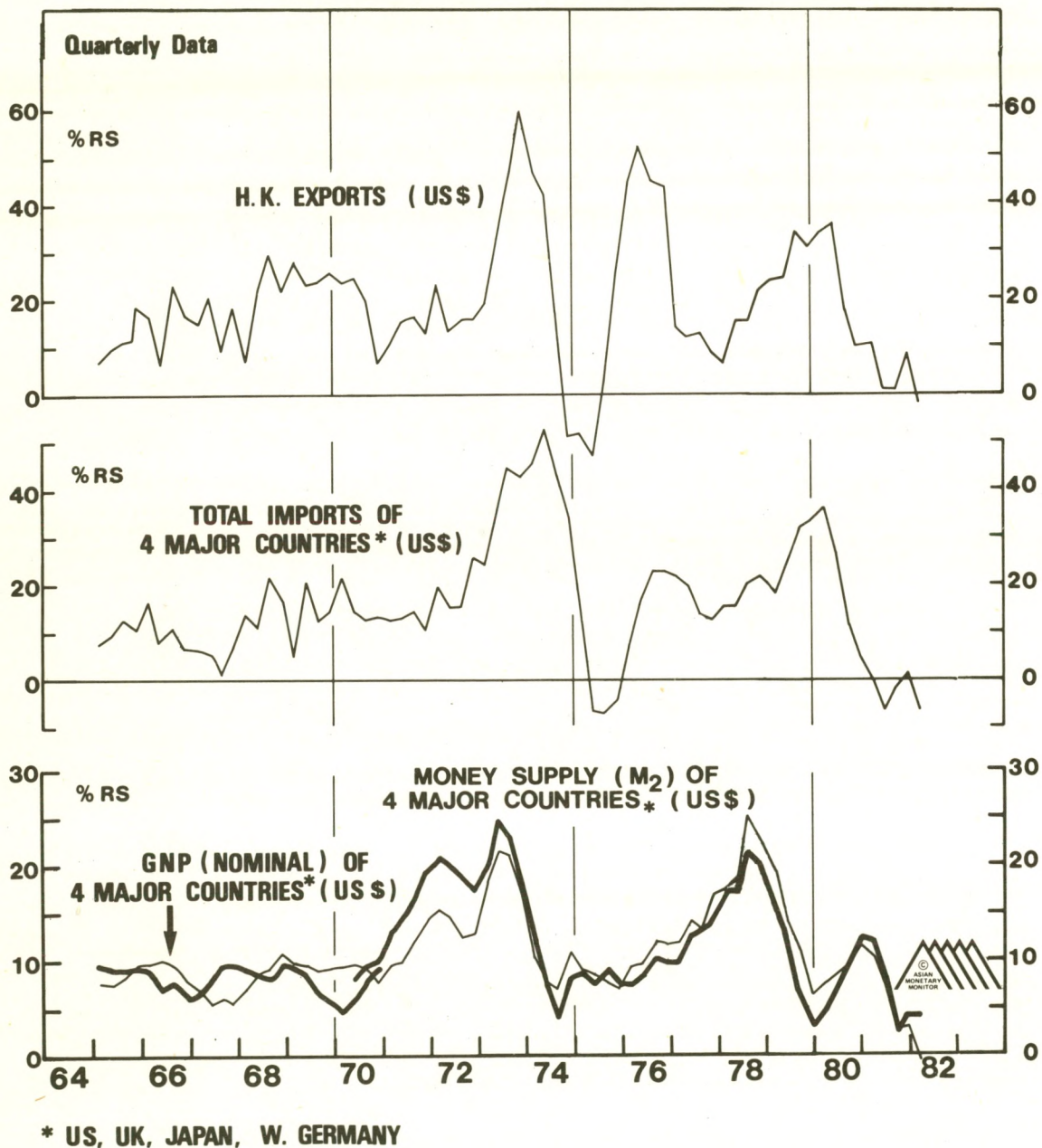
The key factor in the international backdrop to the Hong Kong recession is the marked slowdown in global monetary growth over the past two years. Measured in US\$ the range for the aggregate money supply growth for 4 major countries has declined to between 2% and 12%, a range comparable with the pre-1971 era. In Chart 1 some of the fluctuation in the global money supply total arises from exchange rate fluctuations (so a strong US\$ lowers US\$-denominated monetary growth) but in all major economies monetary expansion has decelerated to a slow pace, and this has brought down the total.

However, an equally important factor has been the shift in monetary policy in Hong Kong itself. For the first time in several years monetary growth has finally slowed down, and this has been reflected in numerous domestic economic indicators.

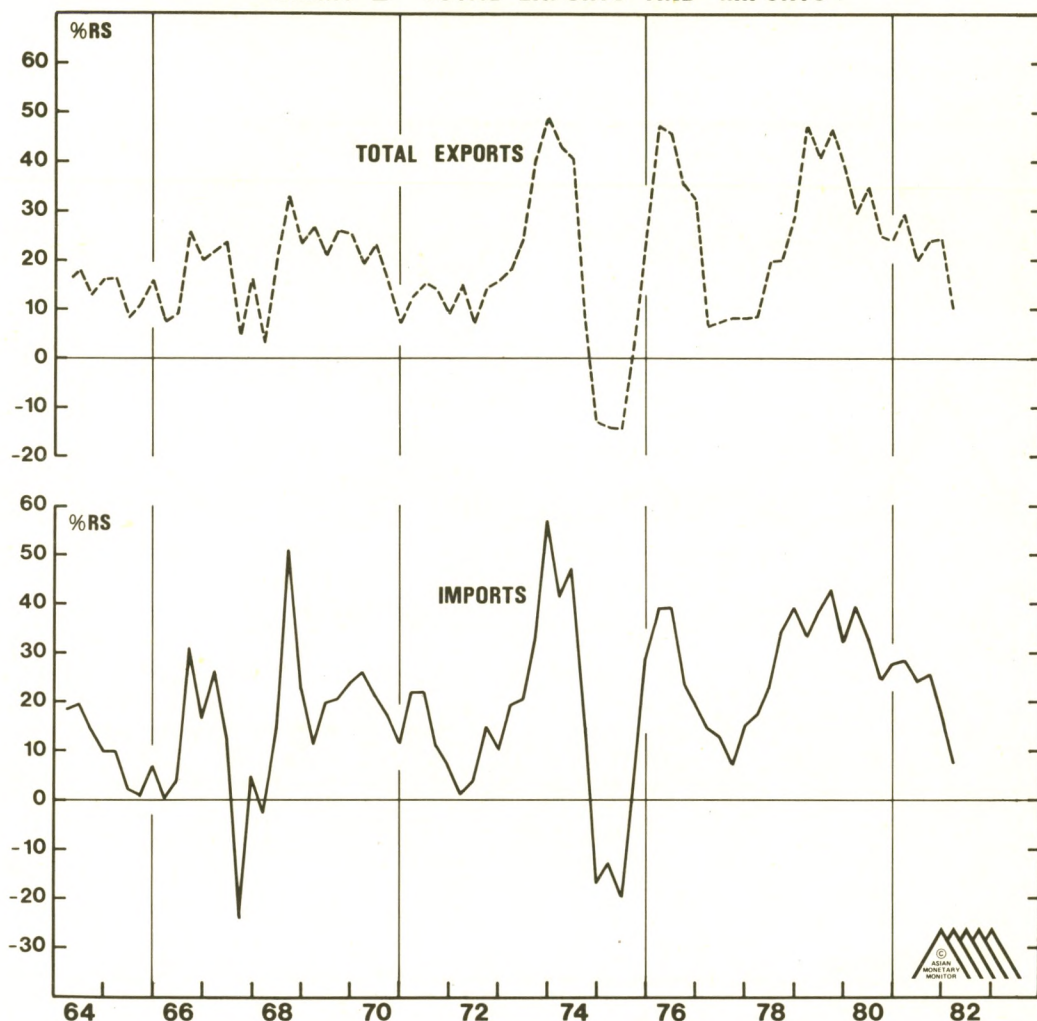
Since the formation of the Hong Kong Association of Banks in 1980/81 the authorities in Hong Kong have placed increased emphasis on the setting of interest rates (or "the interest rate weapon") as the key instrument of monetary policy. (See box on p. 22) In effect the authorities have admitted that the peculiarities of Hong Kong's financial system make direct or indirect control of the money supply impossible. Direct

HONG KONG

CHART 1 : DETERMINANTS OF HONG KONG EXPORTS



HONG KONG
CHART 2: TOTAL EXPORTS AND IMPORTS

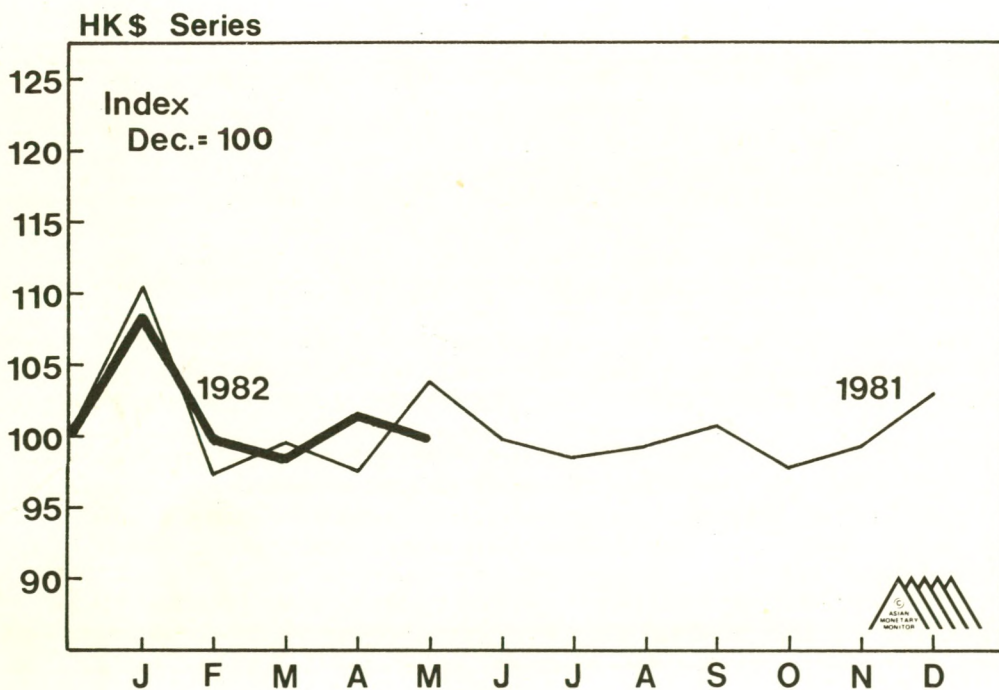
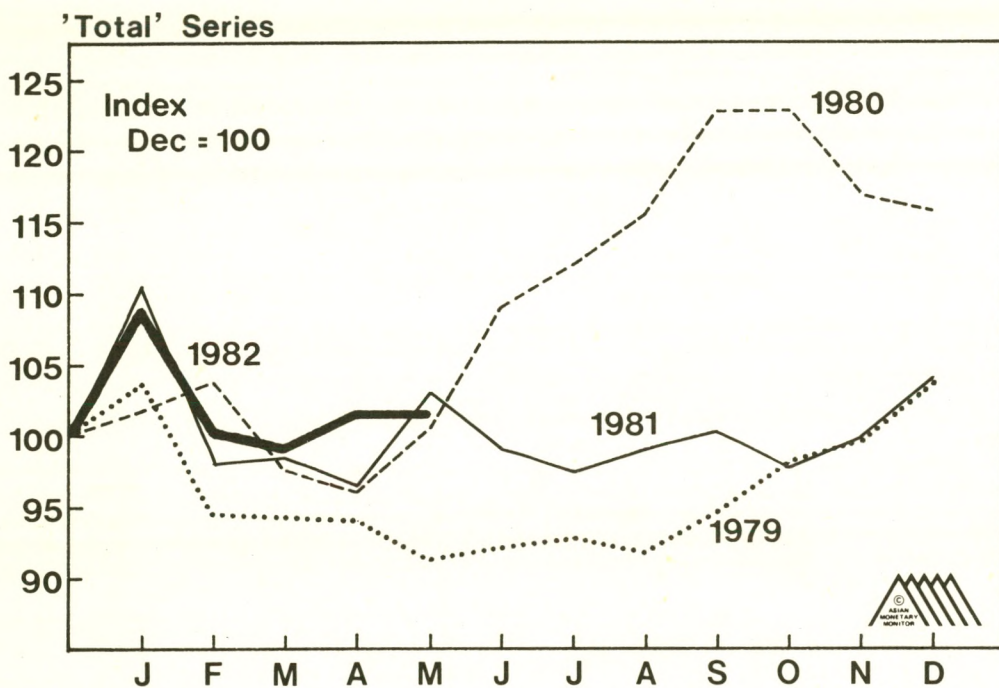


control via regulating the monetary base or bank reserves is impossible because Hong Kong's banks and DTC's do not hold reserves in the conventional sense of holding deposits with the monetary authorities; indirect control via setting the exchange rate is impossible because intervention in the foreign exchange markets by the authorities in Hong Kong does not have multiple expansionary or multiple contractionary effects. In other words, because the system is not a conventional fractional reserve banking structure the authorities lack the standard instruments to enforce policy in either of these two ways.

Controlling reserves and hence directly affecting the money supply is, in the case of most major economies, the best option. Managing the exchange rate and hence allowing the balance of payments to influence the money supply is usually the second best option, except in the case of small countries where it is sometimes the best option. But undoubtedly the worst option is the method of managing interest rates and hence allowing fluctuations in the demand for credit to influence the

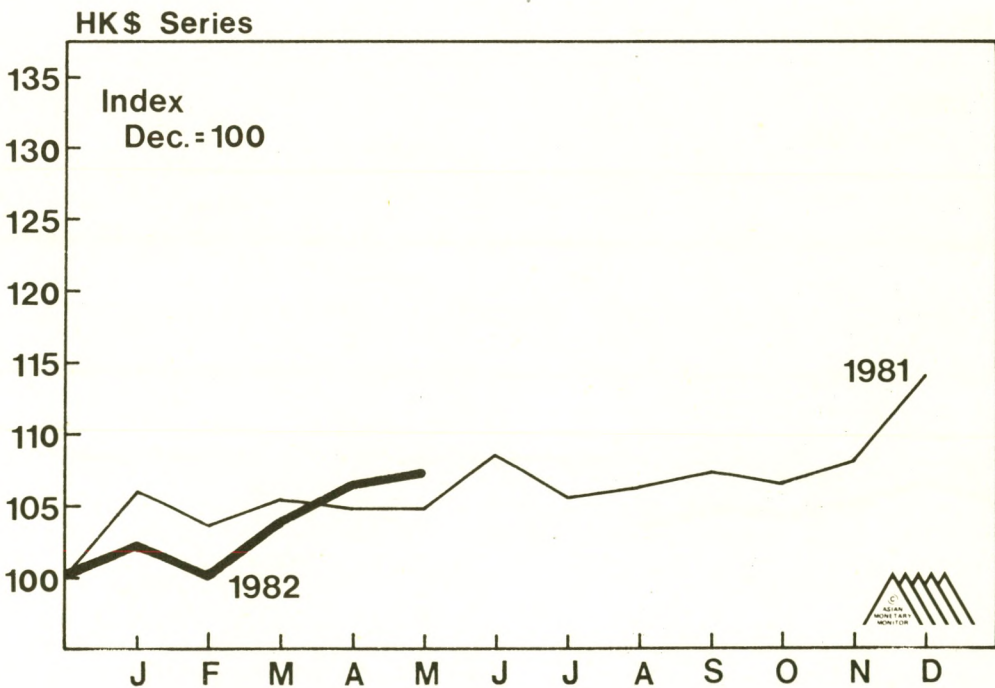
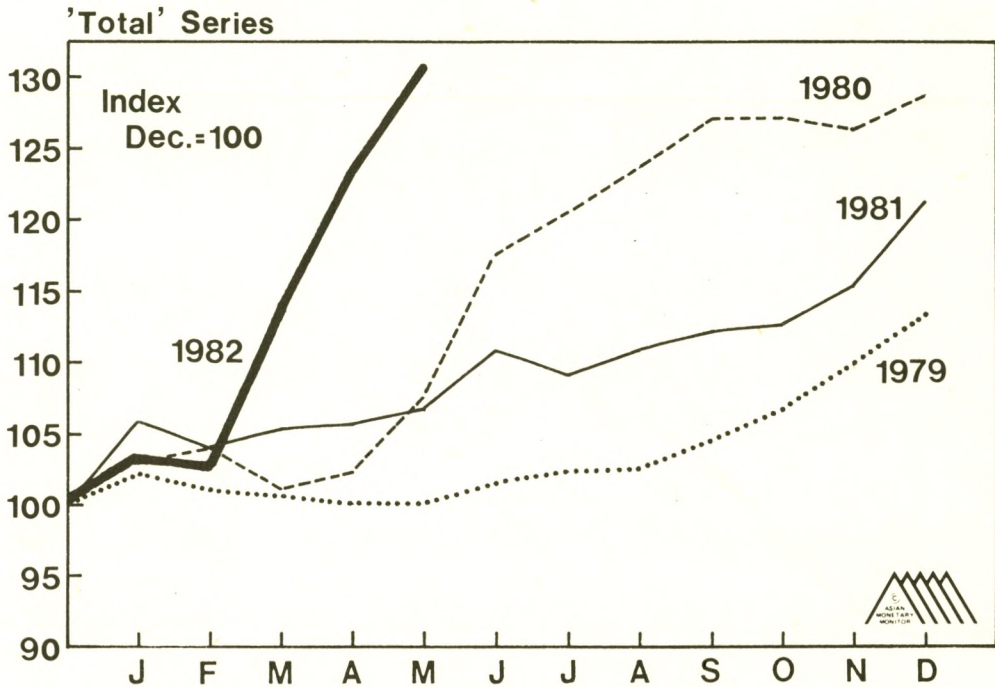
HONG KONG

Chart 3 : Index of Money Supply (M_1)



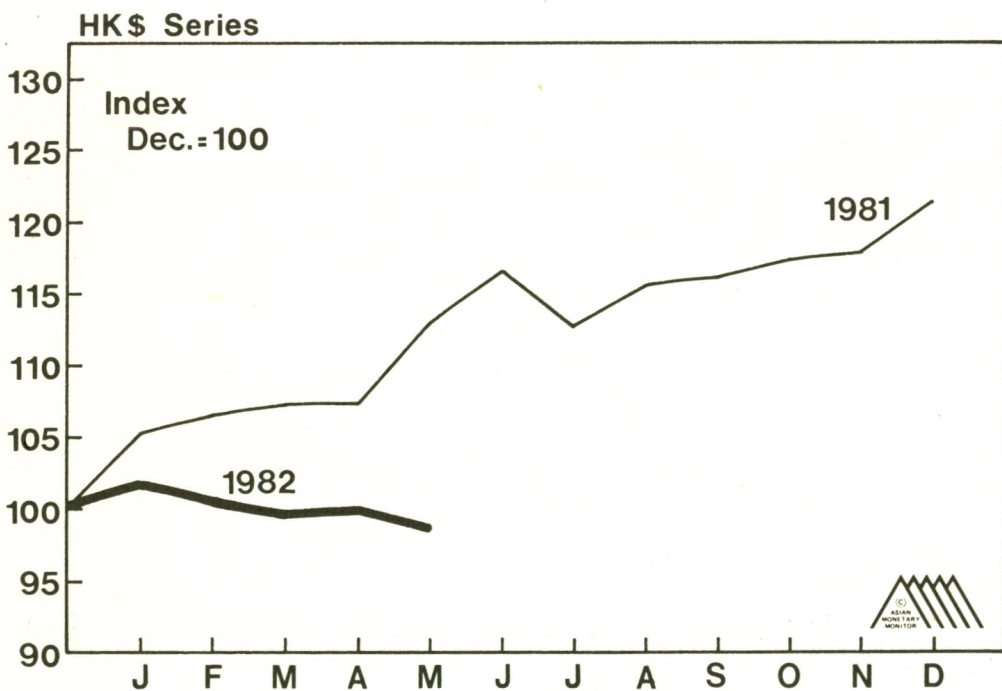
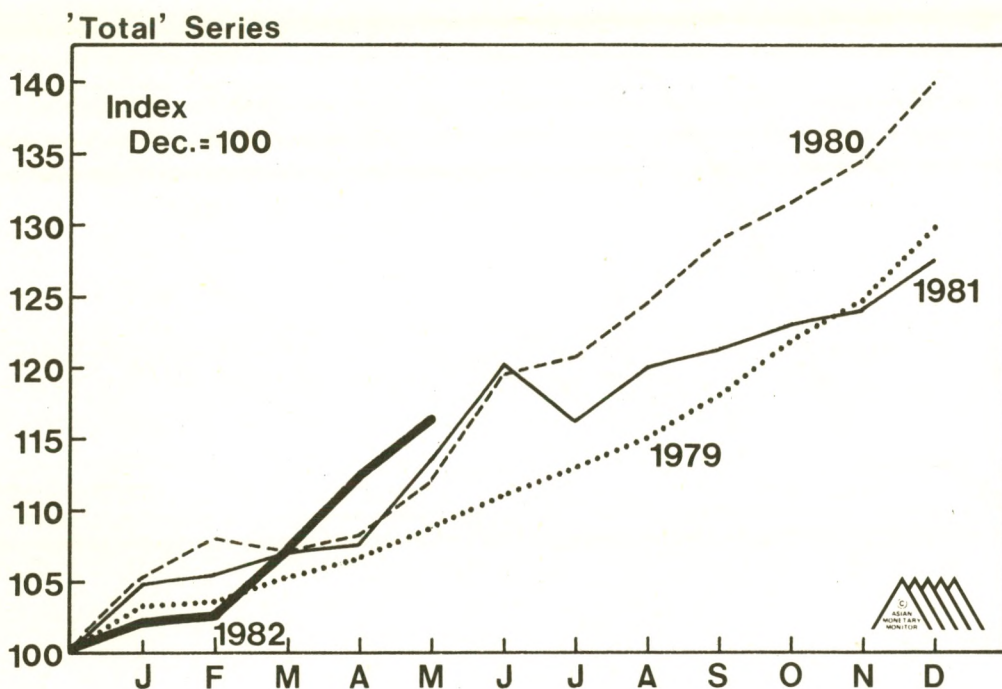
HONG KONG

Chart 4: Index of Money Supply (M_2)



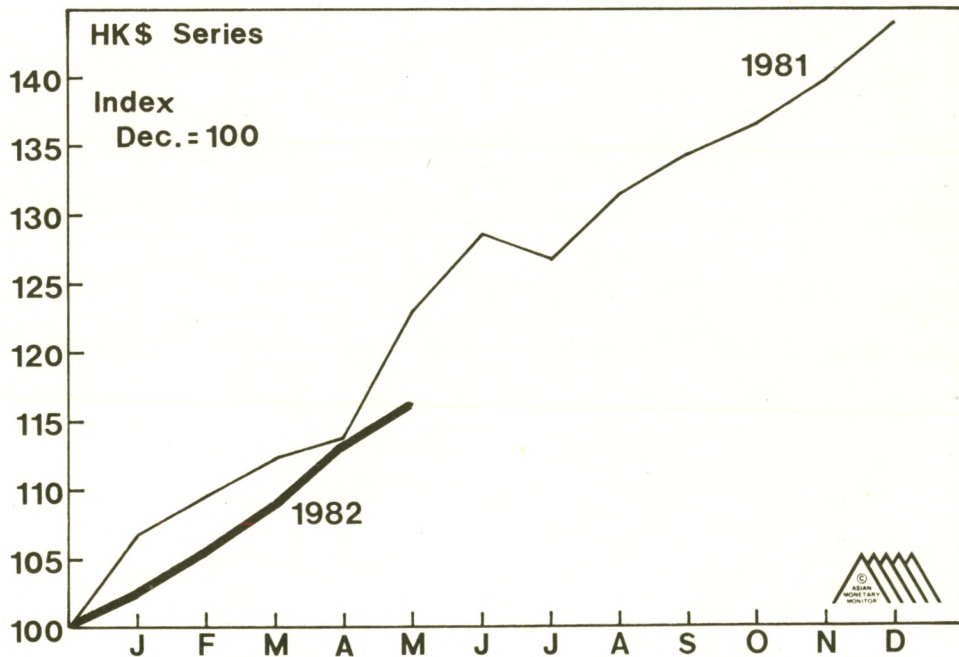
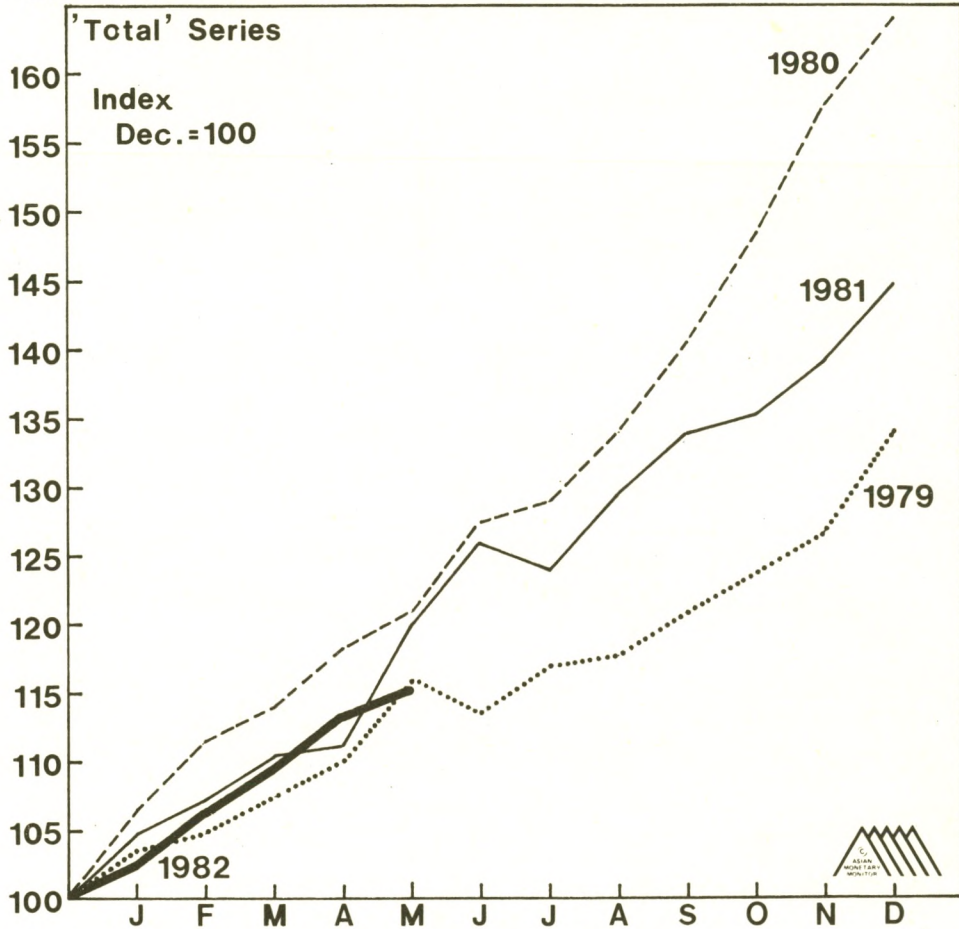
HONG KONG

Chart 5: Index of Money Supply (M_3)

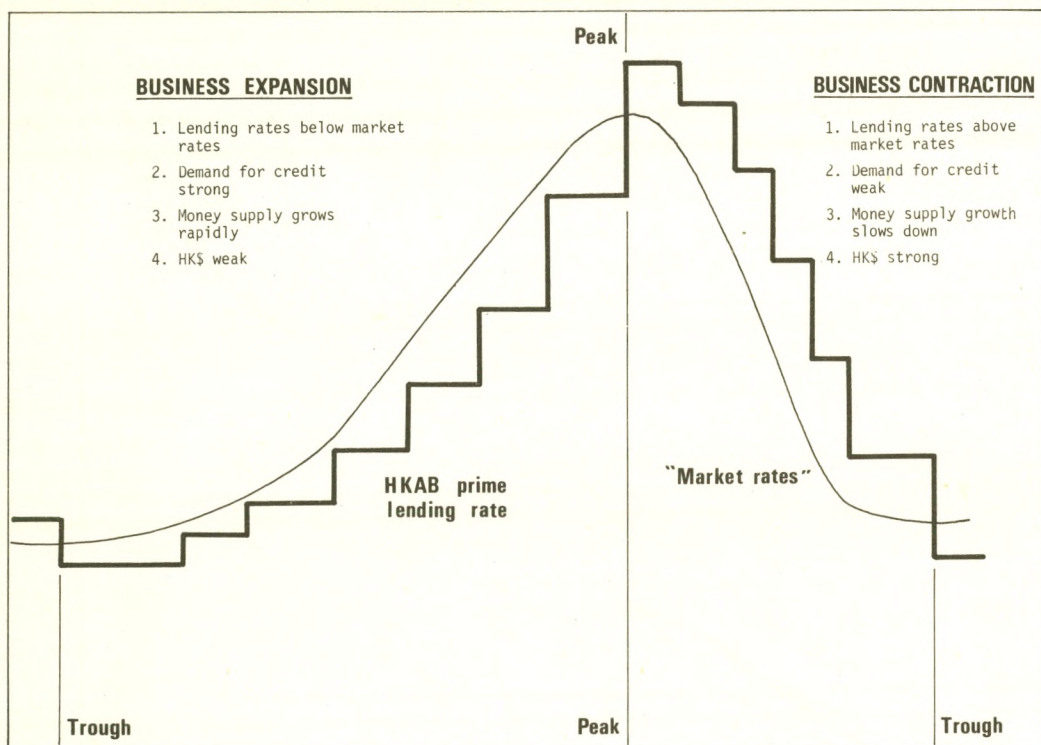


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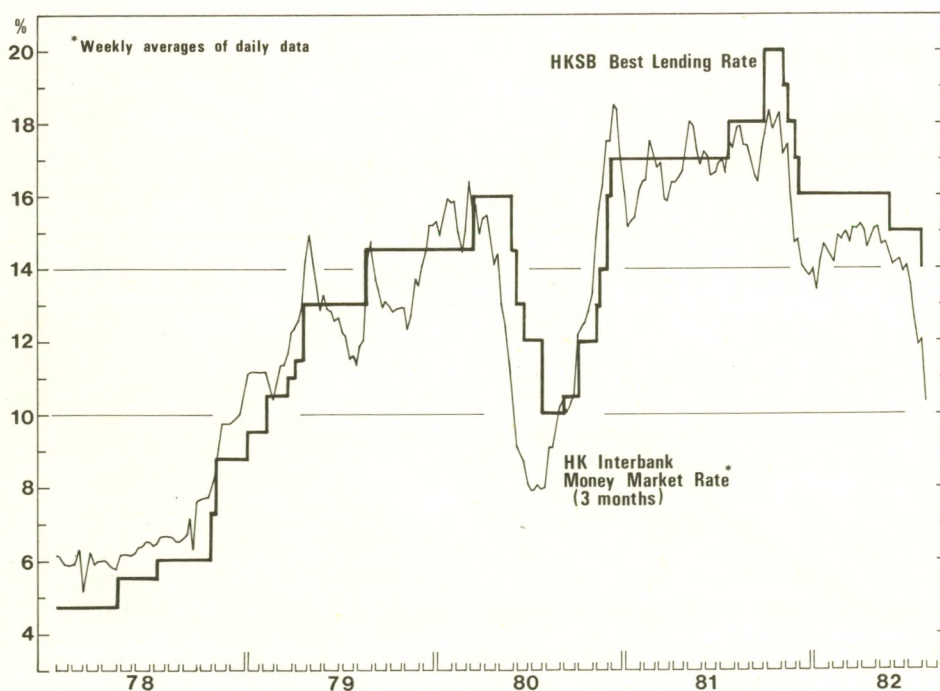
Chart 6: Index of Total Domestic Loans and Advances



IN THEORY,



AND IN REALITY....



A HYPOTHESIS FOR THE HONG KONG CREDIT CYCLE

In any system where prices are regulated markets will not clear. Accordingly demand for the commodity in question will tend to be either excessive or far below the amount that could be offered at that price.

In the market for bank credit the same principles apply. When interest rates are fixed too low, the demand for credit will be very strong, and consequently credit expansion and money supply growth will tend to be very rapid. Conversely when interest rates are fixed too high, the demand for credit will be very weak, so that credit creation and money supply growth will tend to slow down.

In Hong Kong interest rates are set by a committee of the Hong Kong Association of Banks (HKAB) which is a legalised banking cartel. Its deliberations are directly influenced by the Financial Secretary and the Secretary for Monetary Affairs. The licensed banks are obliged to abide by the so-called Interest Rate Agreement on customer deposits of less than 18 months maturity and under HK\$500,000. Banks individually set their lending rates depending on the cost and source of their deposit bases, but in practice the rates are fairly uniform. These 'prime' or 'best' lending rates are the key rates. Because the committee meets just once a week (it used to be fortnightly) and because the agreed rates tend to reflect the authorities' view of where rates should be (or where the exchange rate should be) rather than actual market forces these lending rates are somewhat rigid, and they tend to lag behind developments in the market.

During the expansion phase of the business cycle the demand for credit will be growing as trade and business activity pick up, as investment in property, capital equipment and inventories accelerate, and as inflationary expectations rise. Typically free market interest rates will run ahead of bank lending rates, and because lending rates will appear cheap relative to market rates or relative to inflation the demand for credit will be extremely strong. Bank credit and money growth will grow very rapidly so that despite the rising trend of interest rates the Hong Kong dollar will tend to be weak.

Gradually, as fears about overheating, speculation, inflation and a weakening HK\$ intensify, the authorities and the HKAB will agree on the need to take action. Right at the peak of the business cycle they will finally jack up lending rates above 'market' rates, just as they did in October 1981.

Conversely during the contraction phase of the business cycle the demand for credit will be weakening as business activity and trade slow down, as plans for investment in property development, capital equipment and inventories are shelved, and as the inflation psychology gives way to a deflationary mentality. Because bank lending rates are now above free market rates, and because lending rates will appear high in relation to the falling inflation rate, the demand for credit will be weak. Bank credit and money growth will grow more slowly so that despite falling interest rates the Hong Kong dollar will tend to be strong.

Finally, as fears about recession and unemployment increase, and as a strengthening HK\$ discourages an export-led recovery the authorities and the HKAB will at last agree to get the economy moving again. Right at the trough of the business cycle they will allow lending rates to drop below 'market' rates, and the whole process will start all over again....

HONG KONG'S MONETARY MUDDLE - THROUGH

Leaving aside direct quantitative credit controls, there are three main avenues of approach to the problem of controlling monetary growth.

<u>Lever</u>	<u>Fulcrum</u>	<u>Impact</u>
1. Direct control of bank reserves	Money multiplier	Money supply will grow at a known rate, but interest rates and the exchange rate will fluctuate in response to domestic and foreign economic conditions. Inflation cannot be 'imported' because monetary growth is domestically determined.
2. Managing the exchange rate	Balance of payments	Money supply will grow at varying rates depending on the state of the balance of payments. Interest rates respond to fluctuations in the demand for credit at home and abroad. Inflation will approximate to the inflation rate in the country (or countries) to whose currency(ies) the local currency is pegged.
3. Controlling interest rates	Demand for credit	Money supply will grow at varying rates depending on the demand for credit at the particular interest rate set. The exchange rate will fluctuate in response to the relative demands for credit at home and abroad. Inflation will depend on the money growth rate which will depend on the demand for credit, which in turn will depend on whether interest rates are set too high or too low.

To control monetary growth and hence inflation one can either control the quantity of money via regulating the availability of reserves (1), or the price of money, (2) or (3).

The Hong Kong authorities cannot control bank reserves (1) because the Exchange Fund does not exercise any influence on bank reserves, and Liquid Assets are not amenable to control.

The exchange rate (2) represents the price of money in an absolute and definable sense; it is the quantity of foreign currency which a unit of the domestic currency can purchase at any given time.

Interest rates (3), however, are not such a reliable tool because interest rates are the price of credit (rather than the price of money), and as such they only relate the present and future values of usable funds, which is a highly elastic and variable measure.

In practice the Hong Kong authorities have muddled through by employing interest rates as an indirect method of affecting the exchange rate. Since the collapse of the Hong Kong dollar in August/September 1981 they appear to have tried to keep the HK\$ in a band somewhere between HK\$5.80 and HK\$6.00 to the US currency, but since the US\$ has been exceptionally strong over this period the result has been that HK\$-denominated monetary growth has virtually come to a halt. In other words, in accordance with the theory set out on pp. 20-21 Hong Kong has swung from excessive money growth in 1979-80 to the opposite extreme today.

money supply. Yet this is the option chosen by Hong Kong. As indicated in the box on p.22, this can result in a money growth rate which is determined in the first instance by the demand for credit, and ultimately by the fickle finger of expectations.

Not surprisingly, monetary growth in Hong Kong has consequently been highly erratic, varying from excessive expansion last year to virtually zero growth this year. A hypothesis to explain the mechanism underlying the violent cycle of monetary expansion and contraction in Hong Kong is set out on page 20.

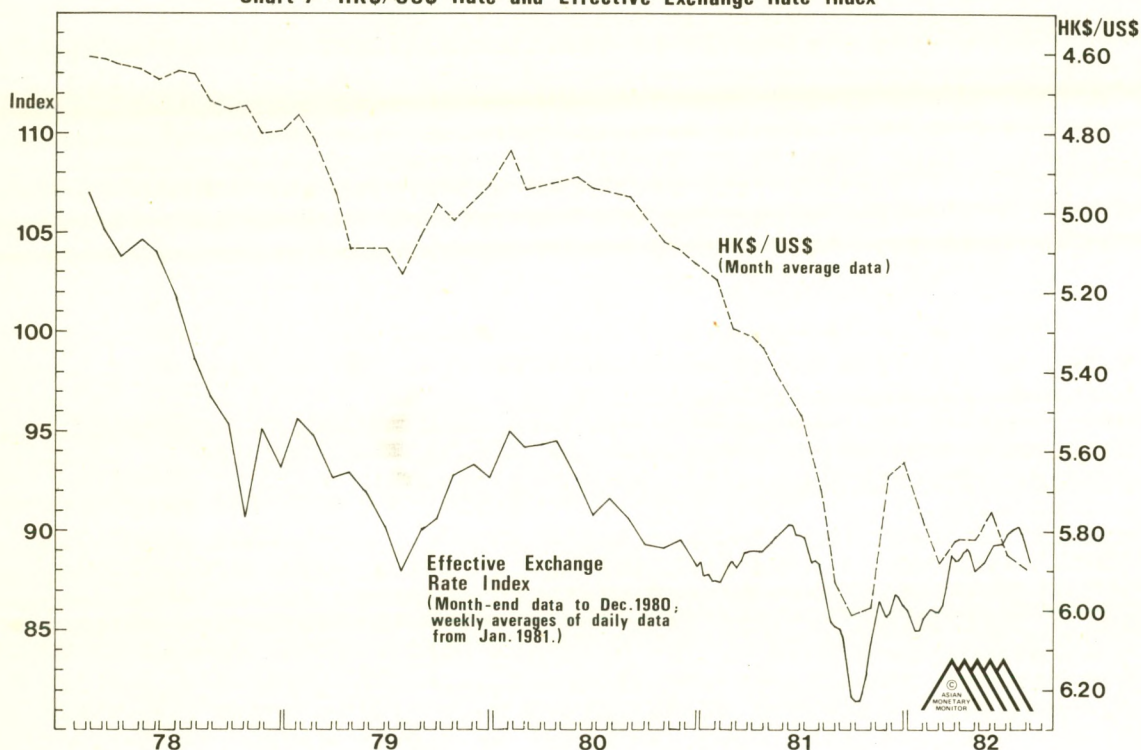
Apart from the general policy of maintaining high interest rates to restrain money and credit growth, two factors have affected the money aggregates in Hong Kong. First, there has been a shift of funds since the Hong Kong budget of February 24th this year which abolished the 15% withholding tax on foreign currency deposits, and simultaneously reduced the 15% withholding tax on HK\$ deposits from 15% to 10%. The main effect has been to encourage banks and deposit-taking companies (DTCs) to book in Hong Kong foreign currency loans and deposits which previously were placed offshore to avoid the withholding tax. This shows up very clearly in the Total M2 series which consists of cash held by the non-bank public, plus demand, time and savings deposits at the licensed banks in local and foreign currencies. Since HK\$ M2 has grown very little since the start of the year, and the bulge in Total M2 growth starts in March it is clear that the growth is due to the growth of foreign currency deposits since the Budget. (See Chart 4.)

A second factor affecting the monetary aggregates has been the erosion of the market share of the registered DTCs. Under Hong Kong's new legislation regulating bank and DTC behaviour, registered DTCs can only solicit deposits in excess of HK\$50,000 and with minimum maturity of three months. Since much of their deposit base previously derived from deposits of less than three months' maturity registered DTCs are being forced to relinquish this type of business and depositors are being forced to place these funds with the licensed banks. An intermediate category of institutions, the so-called licensed DTCs, are not benefiting since they can only take deposits exempt from the Interest Rate Agreement in amounts in excess of HK\$500,000. Thus there is a steady flow of funds from the DTCs back to the licensed banks which is helping to boost HK\$M2 at the expense of HK\$M3. (HK\$M3 includes DTCs; HK\$M2 excludes DTCs. Compare Charts 4 and 5.)

Loan growth continues at quite a strong pace both in HK\$ and in foreign currencies (see Chart 6), which must mean that a significant volume of loans is being funded from foreign currency sources. Insofar as this indicates an inflow of funds to Hong Kong - effectively non-residents lending to residents - this borrowing by Hong Kong entities from abroad has helped to offset the trade deficit and to keep the Hong Kong currency reasonably firm against other currencies. However, if there should for any reason be a decline in confidence in foreigners' perceptions of the investment environment in Hong Kong that

HONG KONG

Chart 7 : HK\$/US\$ Rate and Effective Exchange Rate Index



inflow could easily evaporate and the currency would rapidly weaken unless the authorities stepped into to support it. This would not mean that the banks could not continue to extend credit - the are plenty of ways for Hong Kong banks to do that - but it does suggest that in the absence of a satisfactory system of monetary control Hong Kong's currency is peculiarly dependent upon foreign currency inflows and particularly vulnerable to adverse shifts in sentiment.

FORECAST: The Hong Kong dollar is normally weak during booms and strong during recessions. This tendency stems from the peculiarities of the interest rate mechanism adopted during the past few years in Hong Kong, and occurs because of the inherent likelihood that rates will be kept too low during the business cycle upswing, and will be kept too high during the business cycle downswing. During a trade recession the downturn in economic activity will be compounded by the tendency for HK\$-denominated money supply to slow down very rapidly, thus squeezing domestic purchasing power. Although this has a beneficial effect in forcing Hong Kong to adjust its cost/price structure rapidly, it has some equally important side effects which tend to make economic activity, property prices and equity prices highly volatile. The current downturn is only just beginning to affect Hong Kong seriously, and any sudden weakening of confidence in the trade outlook or in the stock and property markets could temporarily undermine the currency as well.

SINGAPORE

AN INEVITABLE SLOWDOWN

The Singapore economy is an economy which in the past has been thought to be dependent largely upon the growth of world trade for its own economic growth. It is indeed a very "open" economy - in 1981 total exports plus imports were equivalent to close to 400% of the Gross National Product! Yet despite this apparently excessive dependence upon the world business cycle, Singapore achieved growth rates of 10% in both 1980 and 1981 against a backdrop of world recession and stagnation in world trade. How has the Singapore economy proved so resilient, and how long can this resilience be expected to last?

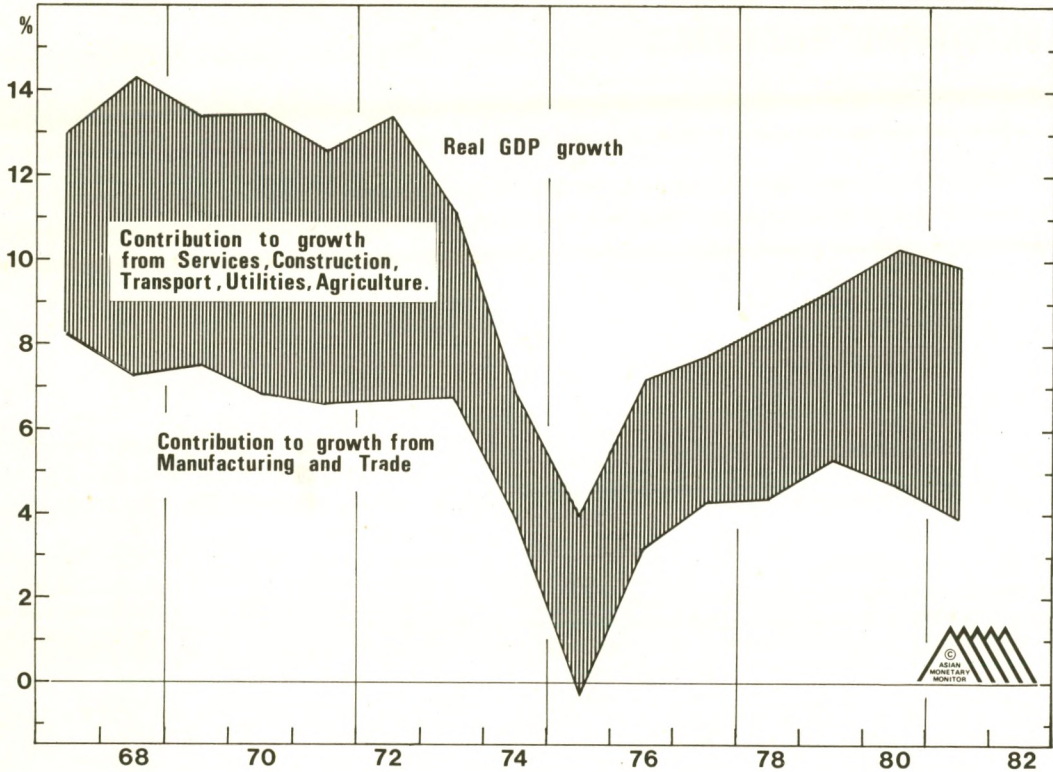
It is true that Singapore has experienced some slowdown this year. The growth rate in the first quarter was 7.3% against 9.9% for the whole of 1981. However, most forecasts for this year's growth are in the 7%-8% range, a rate which, if achieved, would look more than respectable in relation to the rest of the world. These forecasts anticipate high growth as a result of rapid growth in the domestic economy, particularly in the construction and financial service sectors. This has already been evident in the first quarter, when the construction sector grew at over 30% as against 17% for the whole of 1981 and contributed over 17% of the first quarter's GNP growth. The other major contributors to growth in the first quarter were financial and business services, and the transport and communication sectors. The manufacturing sector grew at only 1.6% year-on-year, as against 10% for the whole of 1981, and contributed only 4.3% of the first quarter's GNP growth.

The breakdown of the first quarter's GNP figures only reveals a continuation of trends that have been evident at least since 1979. This is apparent from Chart 1 which illustrates, on an annual basis, the sectoral contributions to real GDP growth between 1967 and 1981. The chart divides the growth rate into that part which can be attributed to the manufacturing and trade sectors and that part which can be attributed to the other sectors, most notably services, construction, transport, utilities and agriculture. The manufacturing and trade sectors have been separated out as those sectors which are most dependent upon the world economy. The trade sector includes wholesale and retail trade, restaurants and hotels as well as entrepot trade, but to the extent that these industries are importantly affected by tourism then their fortunes will tend to depend upon world economic cycles.

Chart 1 shows clearly that manufacturing and trade have not been important contributors to the acceleration of Singapore's growth rate since 1977 and have tended to decrease the growth rate since 1979. In the first quarter of 1982 the whole of the deceleration in growth can be attributed to these sectors. This shift away from the importance of trade and manufacturing is evidence of the diversification of the Singapore economy in the last few years. The government has

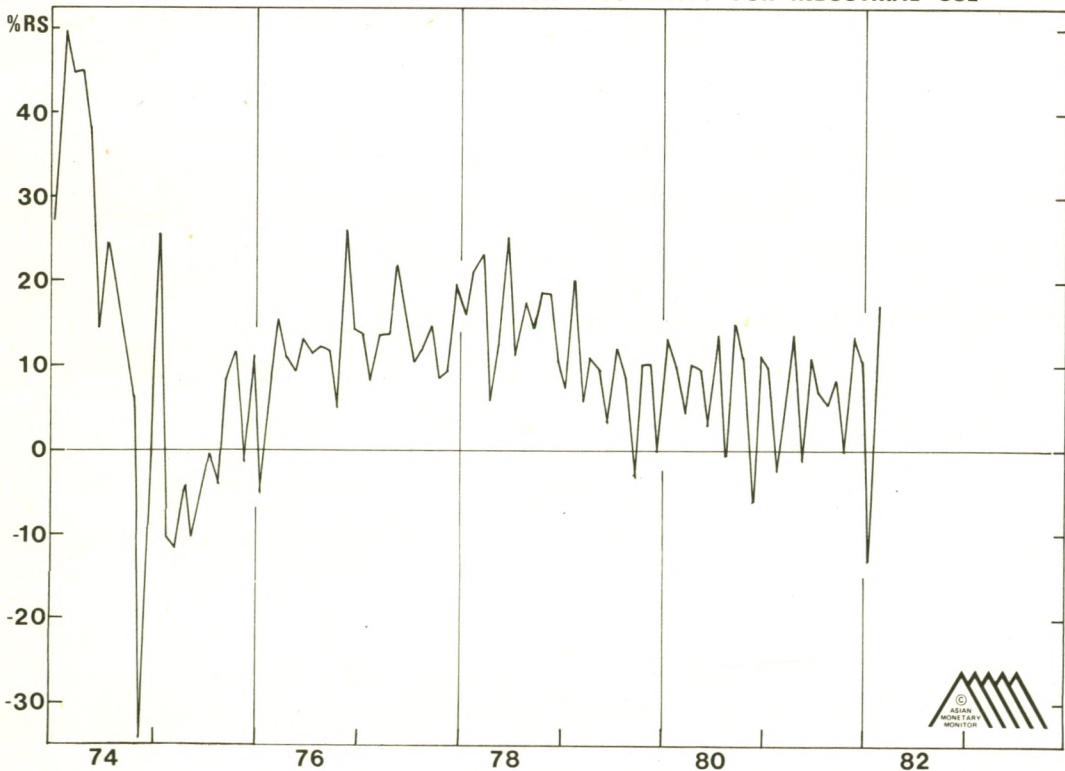
SINGAPORE

CHART 1: SECTORAL CONTRIBUTION TO GROSS DOMESTIC PRODUCT GROWTH

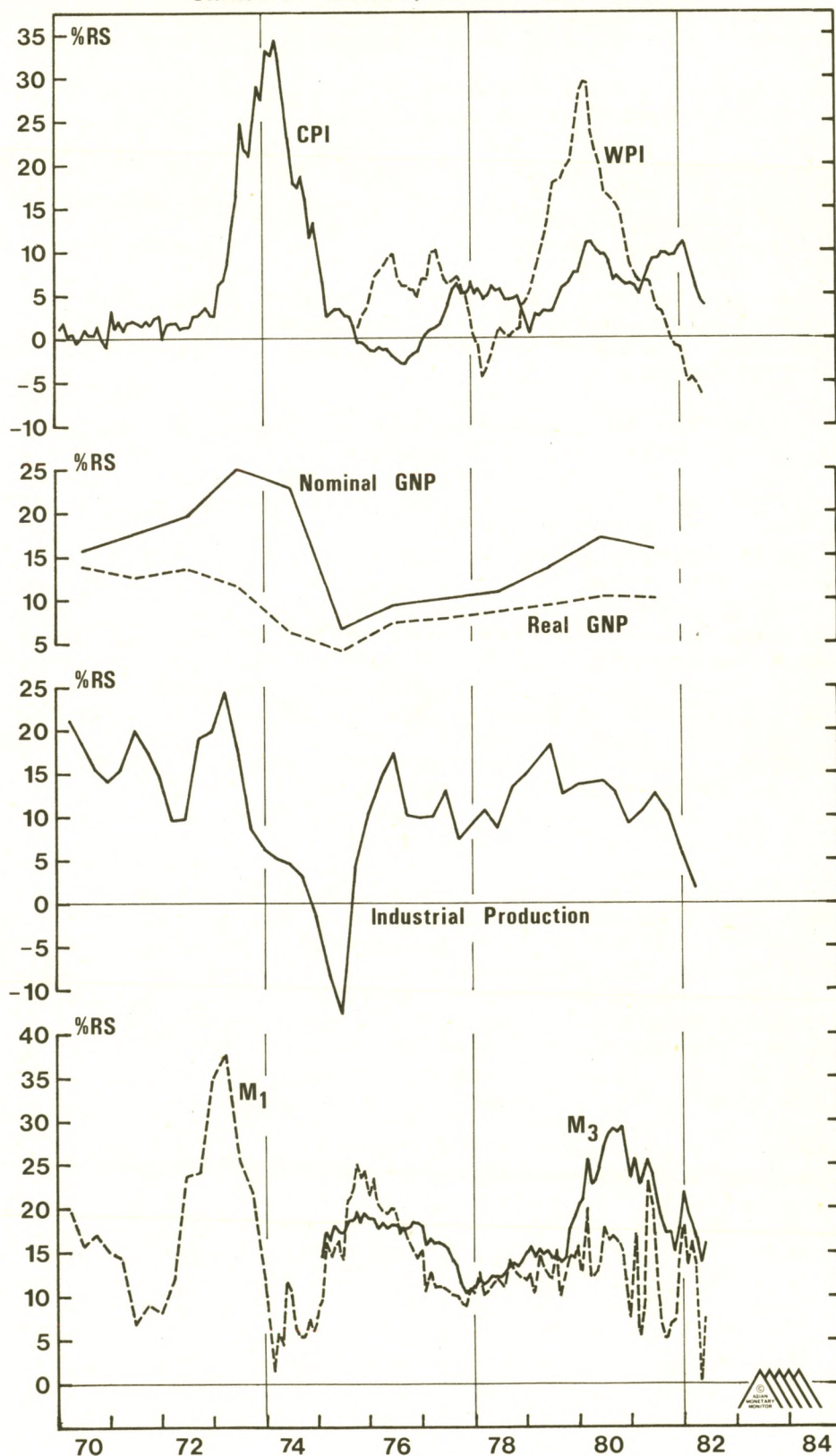


SINGAPORE

CHART 2: SALES OF HIGH TENSION ELECTRICITY FOR INDUSTRIAL USE



SINGAPORE
CHART 3 : MONEY, OUTPUT AND PRICES



encouraged diversification, particularly the growth of financial services, and has also encouraged high productivity growth (through the high wage policy) in an attempt to make Singapore less susceptible to any stagnation in world trade.

The downturn in the manufacturing sector since 1979 can also be clearly seen from an examination of any of the indicators of activity in the industrial sector, such as industrial production or electricity sales to industry (Chart 2). The year-on-year growth in industrial production fell to as low as 1.6% for the first quarter of 1982 (Chart 3). The extent to which growth over the last year has been dependent upon the domestic economy is also reflected in the breakdown of final demand into its external and domestic components. Domestic demand contributed nearly half of the growth of total final demand in 1981, compared to roughly a quarter in each of the years 1979 and 1980.

In attempting to assess whether the Singapore economy can maintain a high rate of growth powered largely by the domestic economy, the obvious constraint to consider is the trade account. The trade deficit in 1981 grew to nearly S\$14 billion, or more than 50% of the total GNP, and continued to grow rapidly in the first quarter of 1982, the deficit for this period being 41% higher than in the corresponding period of 1981. This is perhaps not as worrying as it seems at first sight because, given the high level of direct foreign investment, which has been an essential ingredient of Singapore's high rate of economic growth, it is inevitable that the trade deficit should be large. It is through imports of capital equipment and raw materials that the basis has been laid for future high economic growth and high export growth. Thus, in spite of a more or less continuous deterioration in the trade deficit throughout the 1970's, Singapore has not experienced an overall balance of payments deficit since 1965.

Nevertheless, this is not to say that it would be impossible for Singapore to experience a balance of payments deficit and such an occurrence could well result in a fairly rapid slowdown of the Singapore economy. A balance of payments deficit would tend to mean either a fairly sharp tightening of liquidity or a substantial depreciation of the Singapore dollar. The tightening of liquidity would occur as a result of the effect of the balance of payments upon the monetary base in a situation where the exchange rate is managed.

Historically, due to persistent balance of payments surpluses, the foreign exchange component of monetary base growth in Singapore has been large and positive. However, this has always been partly offset by the contractionary effect of the government's operations and hence, with occasional exceptions, monetary growth has not been excessively high. The government's contractionary influence arises from the build up of its deposits at the MAS, which, although a liability of the MAS are not part of the monetary base and hence act to reduce the growth of the monetary base (see table 1).

TABLE 1

SINGAPORE'S MONETARY BASE, S\$M

Year	SOURCES OF BASE			Total Base	USES OF BASE	
	Net Foreign Assets	Less Govt. Deposits	Less Other Items		Currency	Bank Reserves
1970	3,102	-2,201	-9	892	727	165
1971	4,095	-2,897	-200	998	806	192
1972	4,930	-3,444	-188	1,298	1,005	293
1973	5,800	-3,816	-202	1,782	1,114	668
1974	6,503	-4,191	-462	1,850	1,306	544
1975	7,486	-4,676	-613	2,197	1,638	559
1976	8,262	-4,755	-944	2,563	1,947	616
1977	9,023	-5,423	-697	2,903	2,243	660
1978	11,474	-6,123	-1,981	3,370	2,583	787
1979	12,562	-7,019	-1,704	3,839	2,941	898
1980	13,758	-7,026	-2,392	4,340	3,137	1,203
1981	15,491	-2,442	-8,239	4,810	3,382	1,428

TABLE 2

SINGAPORE GOVERNMENT FINANCE, S\$M

Year	SOURCE OF FUNDS				Equals Total Funds	USE OF FUNDS	
	Revenue	Less Expenditure plus Net Lending	Equals Net Surplus	Plus Net Borrowing		Accumulation of Foreign Exchange	Accumulation of Domestic Cash Balances
1970	1,365	-1,166	199	139	338	323	14
1971	1,520	-1,471	49	840	889	211	678
1972	1,871	-1,657	214	528	742	254	488
1973	2,158	-2,023	135	390	525	120	405
1974	2,690	-2,585	105	754	859	136	724
1975	3,372	-3,088	284	1,243	1,527	214	1,313
1976	3,450	-3,397	53	1,579	1,632	152	1,480
1977	3,702	-3,600	102	1,963	2,065	834	1,231
1978	4,126	-4,084	42	1,548	1,590	967	623
1979	4,710	-4,633	77	1,724	1,801	914	887
1980	6,149	-6,050	99	2,187	2,286	2,053	232
1981	7,663	-6,909	754	2,351	3,105	7,272	-4,167

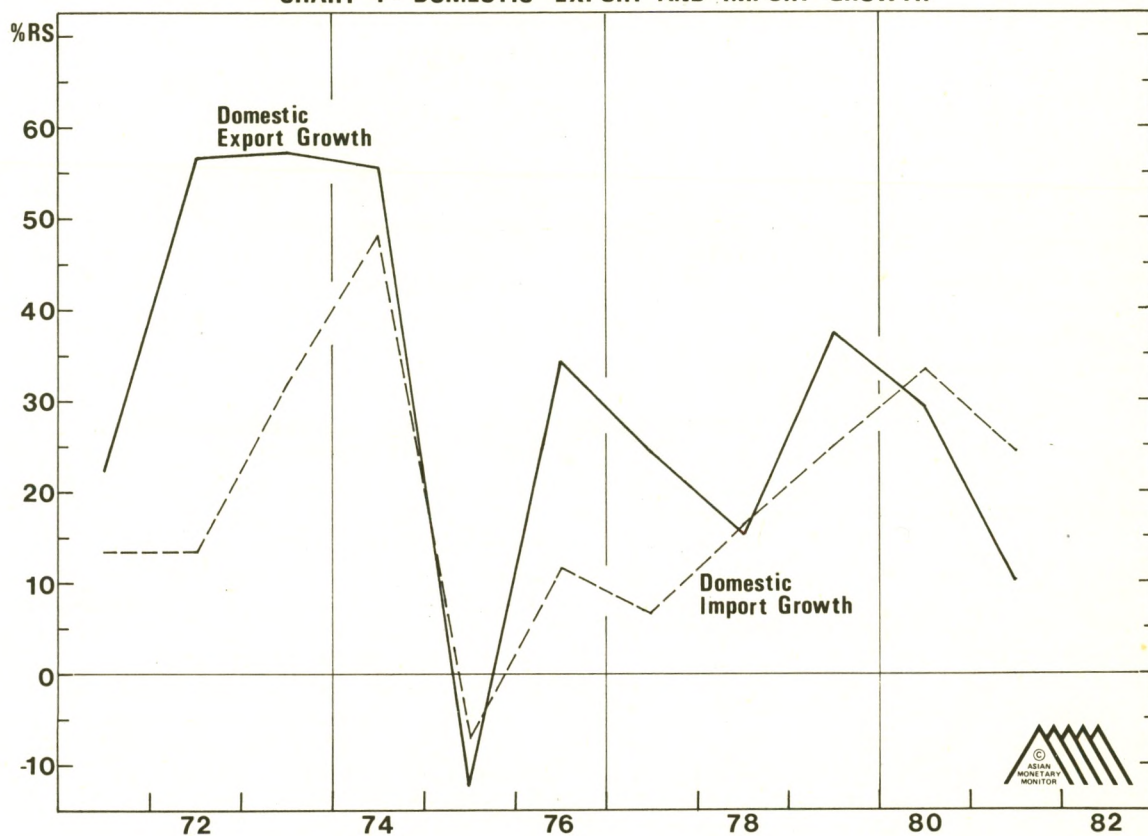
The government is able to accumulate these balances, and balances with the deposit money banks, through its budgetary operations (see table 2). The government always run a small budget surplus but at the same time undertake considerable net borrowings, and hence are able to accumulate funds in the form of foreign exchange or cash balances. The issuance of government debt, despite the existence of budget surpluses, enables the Central Provident Fund and commercial banks to acquire government bonds. The commercial banks need government securities in order to fulfil their reserve requirements. They are required to maintain 10% primary and 10% secondary 'liquid asset' ratios, apart from the cash reserve ratio, and these 'liquid assets' are defined entirely as government debt of various maturities. The final result is that the Central Provident Fund take up roughly 60% of government bonds, the commercial banks roughly 10% and after other public and financial institutions the general public are left with less than 6%.

Accordingly, there is a limited secondary market in government debt and the MAS conducts its monetary policy through exchange rate management using currency swaps as its main instrument. Thus, throughout most of the 1970's the exchange rate was allowed to appreciate and this kept monetary growth under control. The exception was in 1980 when the MAS allowed monetary growth to explode in an effort to keep interest rates down. This is similar to the policy the MAS has generally been following over the last year, particularly in the last quarter of 1981. The MAS has been concerned to keep interest rates down in order to stimulate the domestic economy and to weaken the exchange rate in order to stimulate exports. To this end they have allowed the monetary base to grow relatively rapidly and the result was that M1 growth accelerated from 7% year-on-year in September to 18% by the end of 1981.

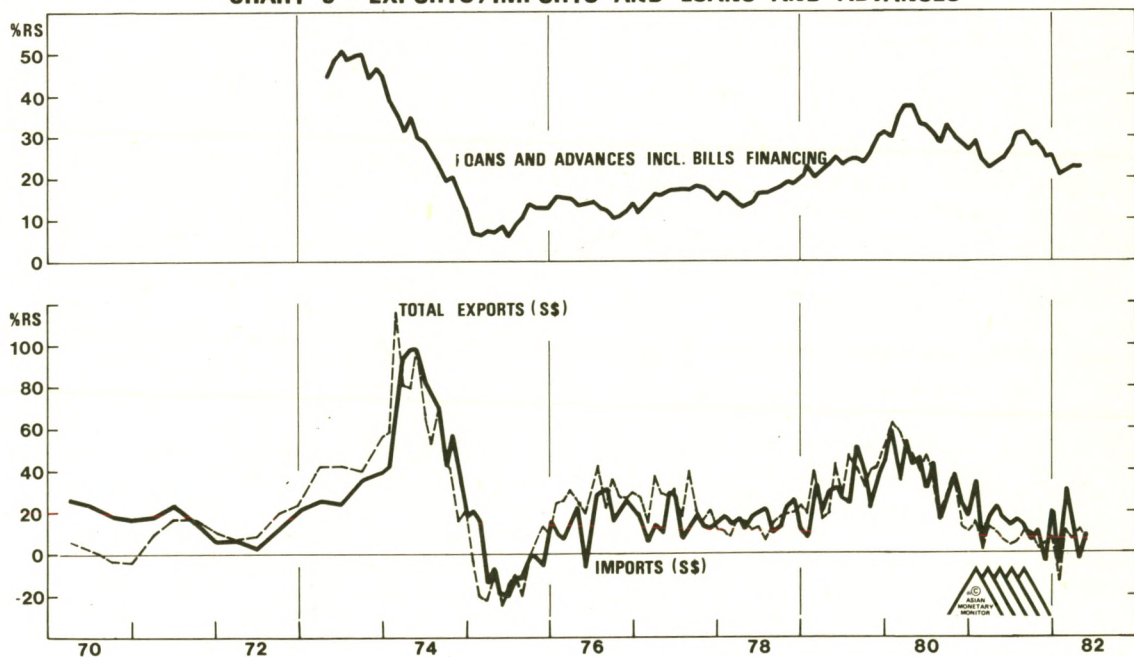
The converse of trends in the 1970's would be that if the balance of payments were to move into deficit, with the government remaining a contractionary force, then liquidity would become tight unless the exchange rate was depreciated sharply. This tightening of liquidity would quickly lead to a slowdown in the economy which would correct the balance of payments deficit. Thus, in attempting to assess Singapore's growth prospects an important factor for consideration is likely trends in the overall balance of payments. In turn an important part of this is the trade deficit.

It is difficult to assess trends in Singapore's trade balance, partly because trade with Indonesia is not published and partly because a large proportion of Singapore's imports are imports for re-export and hence not a function of demand in the domestic economy. Charts 4 and 8 represent an attempt to estimate, on an annual basis, trends in the domestic trade deficit i.e. domestic exports minus retained imports. Officially petroleum is defined as a domestic export and retained import in that crude petroleum is retained for refining before export. However, because the value added by this process is small in relation to its total import requirement we have chosen to deduct petroleum from our estimates of retained imports and domestic exports. Retained imports or

SINGAPORE
CHART 4 : DOMESTIC EXPORT AND IMPORT GROWTH



SINGAPORE
CHART 5 : EXPORTS, IMPORTS AND LOANS AND ADVANCES



'domestic imports' have been calculated by deducting re-exports minus estimates for value added from total imports.

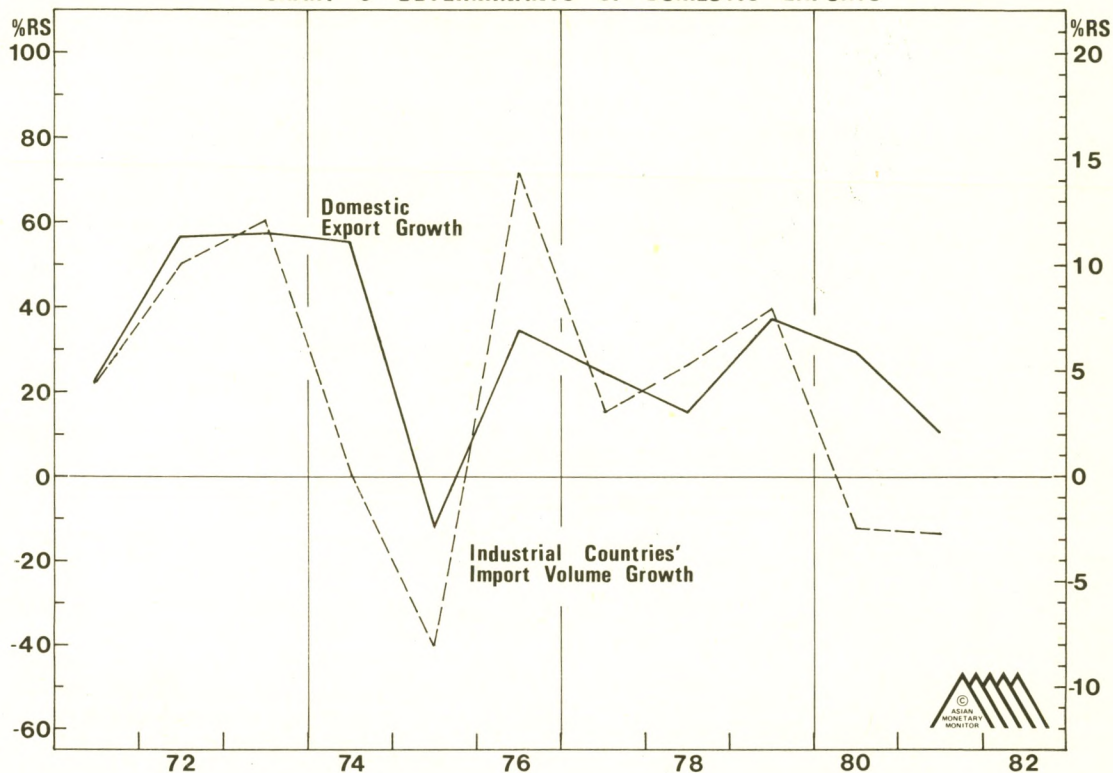
Chart 6 relates domestic export growth on an annual basis (in value terms) to the growth in the total volume of industrial countries' imports, and Chart 7 relates domestic import growth to nominal GDP growth. On their own these charts suggest that the maintenance of a high growth rate in Singapore against a background of stagnation in the rest of the world will lead to an acceleration of the trade deficit. However, insofar as raw materials for industry constitute a high proportion of imports then obviously an important influence upon import growth is industrial production growth. Thus, as industrial production growth is low and likely to fall further import growth will tend to continue falling.

Chart 8 is interesting because it demonstrates that the major offset to the growing domestic trade deficit has not been direct foreign investment, although this has increased significantly, but the growing surplus on the balance of services. The major components in the growth of the service sector's external surplus have been the growth of tourism and financial services. For tourism, in 1981, net foreign exchange earnings amounted to roughly S\$3 bn. Chart 9 clearly illustrates, as might be expected, that earnings from tourism are cyclical and very much dependent upon cycles in the world economy. The chart shows the relationship between the annual growth in the number of visitors to Singapore and the annual growth of the United States' real GNP. The trend evident on the chart has continued into the first quarter when tourist arrivals in Singapore were only 4.5% higher than their level in the first quarter of 1982.

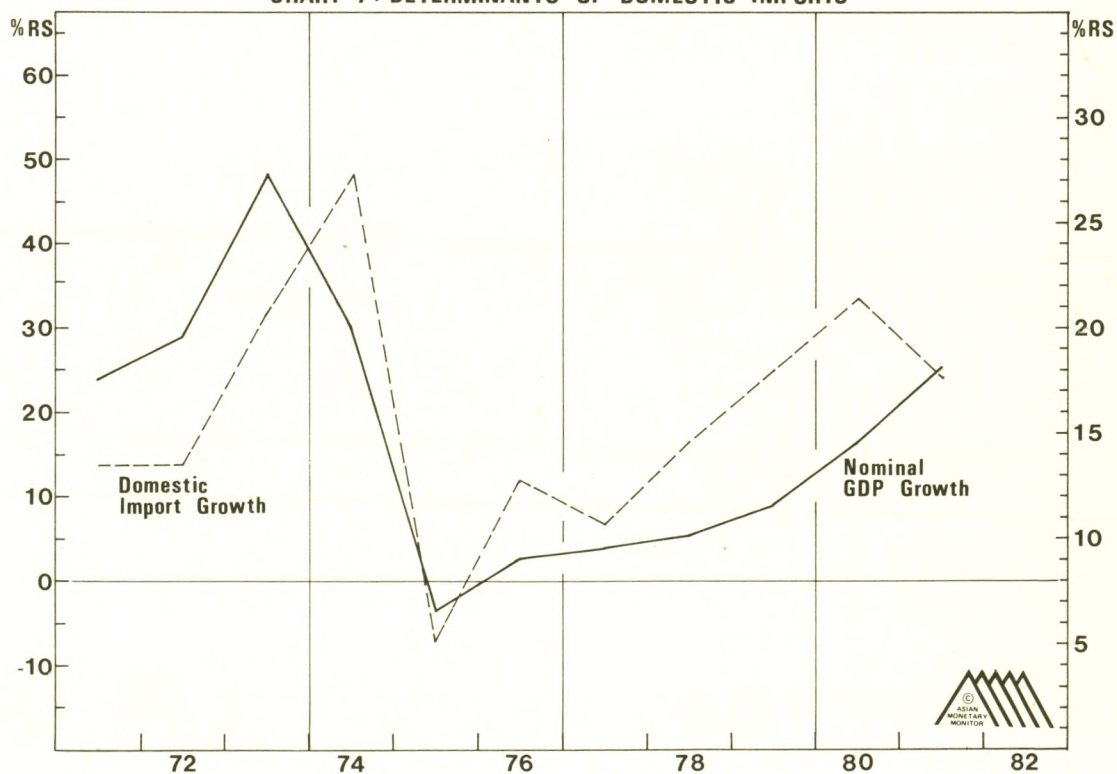
The basic conclusion is that the maintenance of a healthy balance of payments position will depend upon a slowdown in import growth, which may be forthcoming as a result of slow industrial production growth, and the continued growth of financial services and direct foreign investment. Trends in direct foreign investment in fact provide one hopeful sign. Foreign investment commitments in 1981, at S\$1.3 bn. were higher than in 1980, and the rate of growth has been maintained in the first quarter. However, foreign investment commitments are not large enough on their own to support the external position in the event that the other conditions mentioned above did not occur.

FORECAST: In conclusion, Singapore would find it impossible to maintain a high growth rate irrespective of world economic conditions because of its balance of payments constraint. The only way it might be able to do so is through a sharp depreciation of the Singapore dollar, but this is unlikely to occur quickly enough. However, the whole balance of payments problem is unlikely to arise because the downturn in the industrial sector is so severe that, even if the high growth sectors such as construction, financial services etc. continue growing rapidly the growth rate of the economy will drop significantly. It is

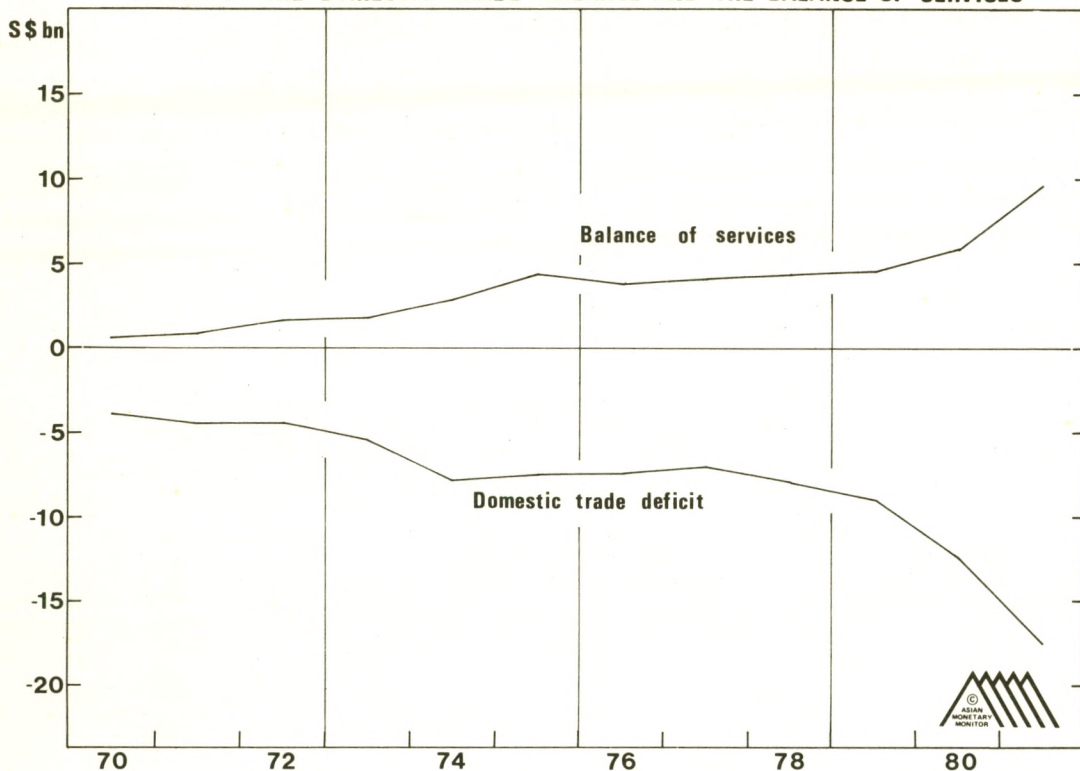
SINGAPORE
CHART 6 : DETERMINANTS OF DOMESTIC EXPORTS



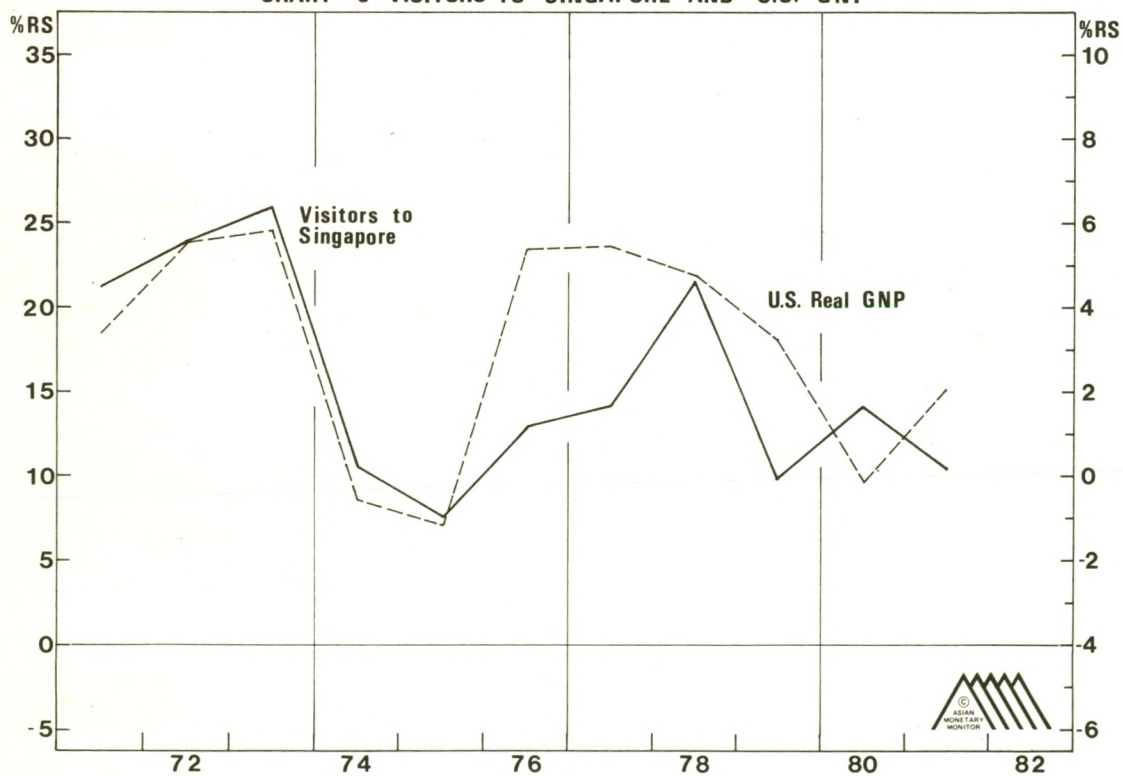
SINGAPORE
CHART 7 : DETERMINANTS OF DOMESTIC IMPORTS



SINGAPORE
CHART 8 : THE DOMESTIC TRADE BALANCE AND THE BALANCE OF SERVICES



SINGAPORE
CHART 9 : VISITORS TO SINGAPORE AND U.S. GNP



unlikely that growth will be supported by domestic demand as it has been before because, with the downturn in industrial production investment will be weak, and with the end of the three year high wage policy, consumption will be weak. In 1981 the growth of private consumption expenditure contributed 30% of the growth of total final demand compared to just 13% in both 1979 and 1980, and private investment contributed 20% compared to 13% and 11% in 1979 and 1980 respectively. With the wage increases just proposed by the National Wages Council being considerably lower than those put into force last year, there is much less scope for further growth of private consumption. In conclusion it seems likely to us that the growth rate of the Singapore economy will continue its recent downtrend and we would not be surprised to see growth at 5% or less within a year.

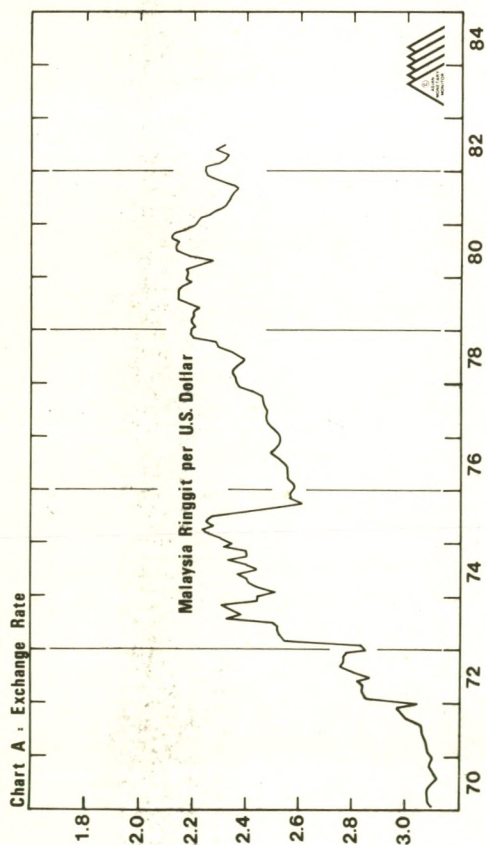


Chart B: Trade Performance

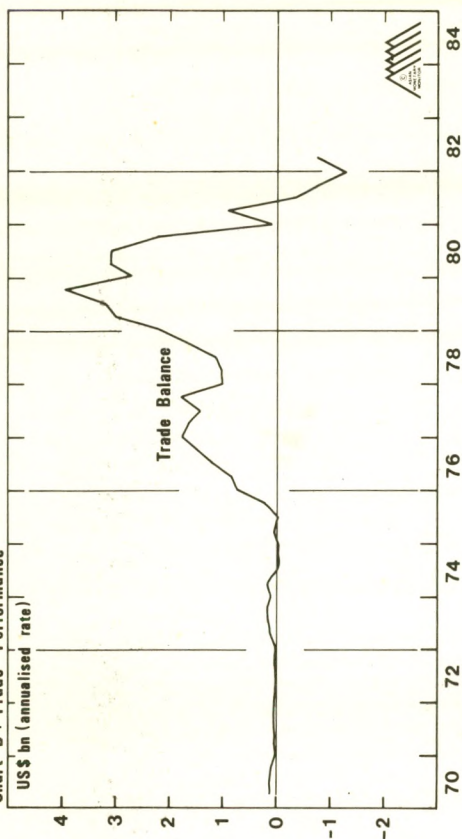
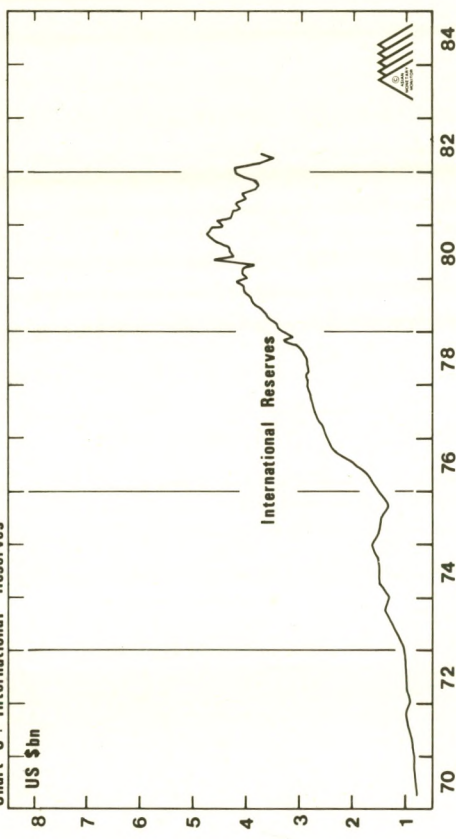


Chart C: International Reserves



The major influence on the Malaysian economy has been the stagnation and decline in the prices of its commodity exports. Rapidly falling prices for rubber, tin and palm oil, and stagnant oil prices have resulted in a severe slowdown in Malaysia's economic growth and a burgeoning deficit on the current account of the balance of payments. In 1981 export revenue fell 8½% leaving Malaysia with its first ever trade deficit which amounted to close on US\$400 m. Chart B illustrates this sharp deterioration in Malaysia's trade performance. Growth forecasts have been continuously revised downwards, the most recent forecast from the Finance Minister placing growth at 5%. The government has responded by scaling back its ambitious development spending program, a program which would have resulted in a budget deficit equivalent to roughly 16% of GNP this year even on previous revenue forecasts.

Yet despite the impact that weak commodity prices have had on the economy, they have had little impact on the external value of the Ringgit. The Ringgit has remained comparatively firm, having depreciated by less than 5% against the US dollar this year. The reason is that large current account deficits have failed to translate into large balance of payments deficits due to the capital inflows arising from borrowing abroad, particularly government

borrowing to finance the budget deficits. In 1981, government borrowing from abroad to finance its deficit amounted to roughly M\$3 bn. and the recently arranged record US\$1 bn. syndicated loan will take borrowings this year above that level. Thus, although the current account position is likely to deteriorate further the overall balance of payments will not show a large deficit. Since this will prevent the currency weakening too far, at least in the medium term, it will further add to the problems of the Malaysian economy in the longer term as import growth will be encouraged and export growth discouraged.

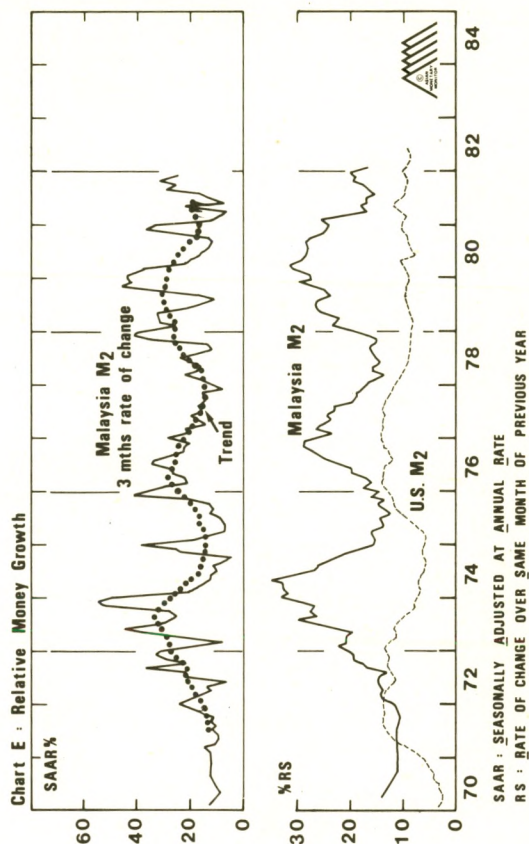
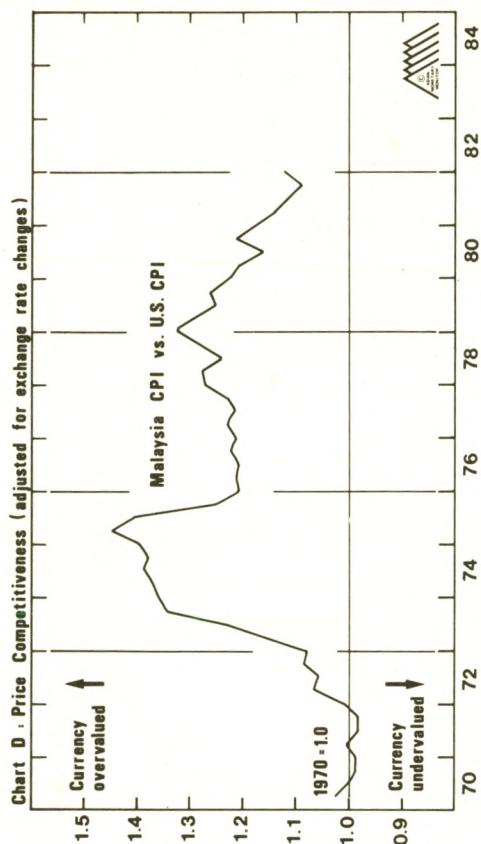
On the positive side, inflation is coming down, the year-on-year rate of consumer price increase for Peninsular Malaysia being roughly 5½%. Chart D illustrates that, on a purchasing power parity basis, the Ringgit is more competitive now than at any time since 1972. However, relative inflation rates influence exchange rates through the trade account and in so far as falling inflation is partly a reflection of the current weakness of commodity prices this need not be bullish for the currency.

The important influences on the Ringgit will be the trend in commodity prices and the level of overseas borrowings. For the medium term this leads us to believe that the Ringgit will continue to depreciate, albeit very slowly, against the US dollar.

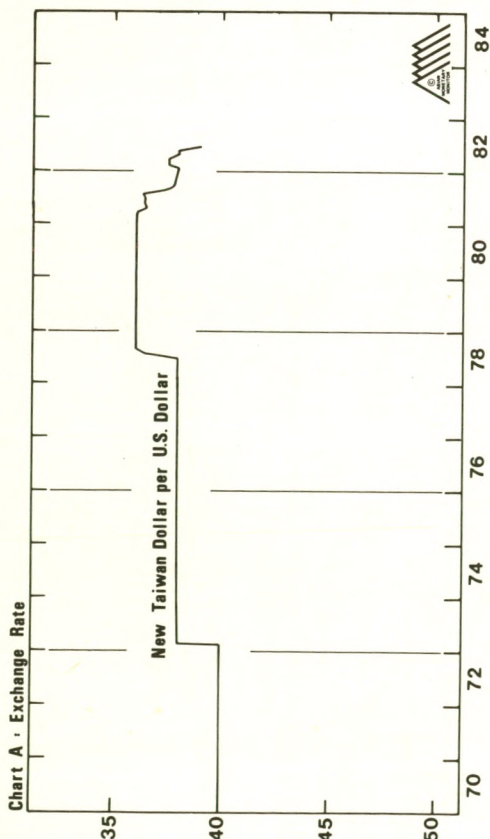
M\$/US\$	ACTUAL		FORECAST	
	1982 Q1	Apr.-May	Q3	Q4
FORECAST A				
Actual Range	2.237-2.337	2.274-2.361	2.36-2.40	2.38-2.45
FORECAST B			2.55	2.55

Forecast A is the most likely exchange rate in the absence of some major political or other external disruption.

Forecast B is based on a simple projection of relative price competitiveness shown in Chart D i.e. the exchange rate necessary to bring US and local price levels into line.



NEW TAIWAN DOLLAR

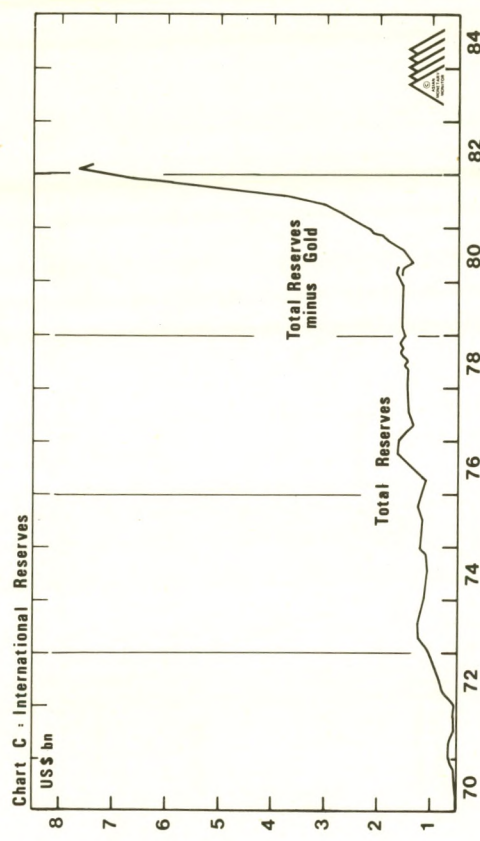
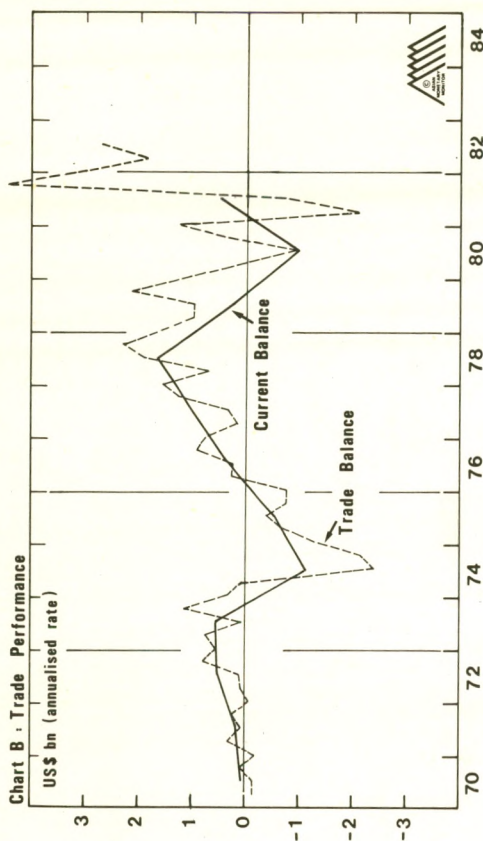


During the 1970s the NT\$ was revalued twice - in February 1973 and July 1978. During the 1980s the currency has been devalued once explicitly - in August 1981 - and more recently by means of a downward slide against the US\$ from NT\$37.50 in February and March of this year to around NT\$39.00 per US dollar. Most of the fall occurred in April and June.

Since the expansionary boom of 1978-79 the Taiwanese economy has been in the doldrums. Industrial production grew by a mere 7.7% in 1980 (compared with 24.9% in 1978), and in 1981 it grew by only 4.3%.

Given the official policy of maintaining a quasi-pegged exchange rate and the strength of the US\$, monetary growth has decelerated from a 22% at the end of 1980 to 18% by the end of 1981 (Chart E). When combined with the sharp downturn in money growth in 1979-80 this has enabled price inflation to fall quite sharply (Chart D) so that wholesale prices are now actually falling on a year-to-year basis, while consumer prices are showing increases of less than 5% year-to-year.

The outlook for the NT\$ depends on the interaction of two sets of factors: (1) official policy towards the management of the exchange



rate, and (2) the adjustment of Taiwan's economy to external developments. The more rigidly the NT\$ is kept pegged to the US\$, the more closely Taiwan will be compelled to follow the cyclical profile of the US economy. Conversely, the more loosely the exchange rate is linked to the US\$, the greater the policy options available. So far the two-stage downturn of the Taiwanese economy in 1979/80 and in 1981 roughly mirror the W-shaped recession in the USA. However, if the exchange rate had been shifted more frequently and by larger amounts Taiwan would enjoy greater autonomy over domestic monetary growth and this would have meant less inflation initially and/or permitted a more gradual slowdown and a more sustainable recovery.

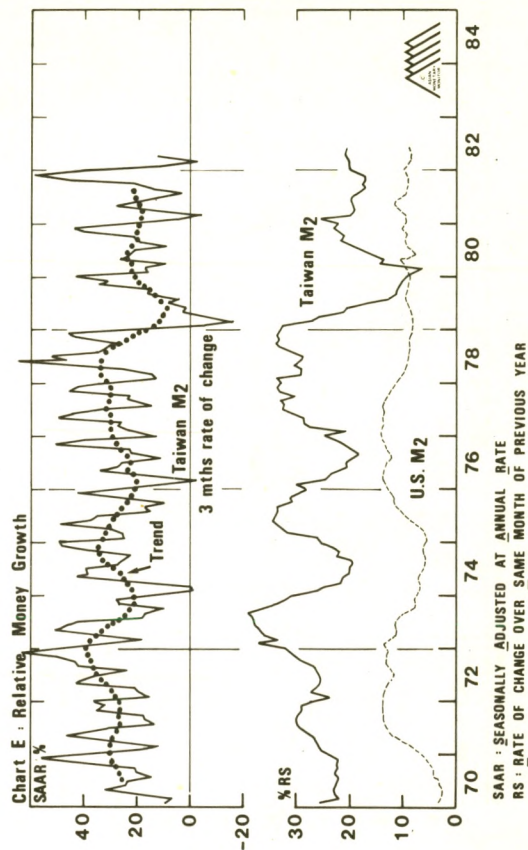
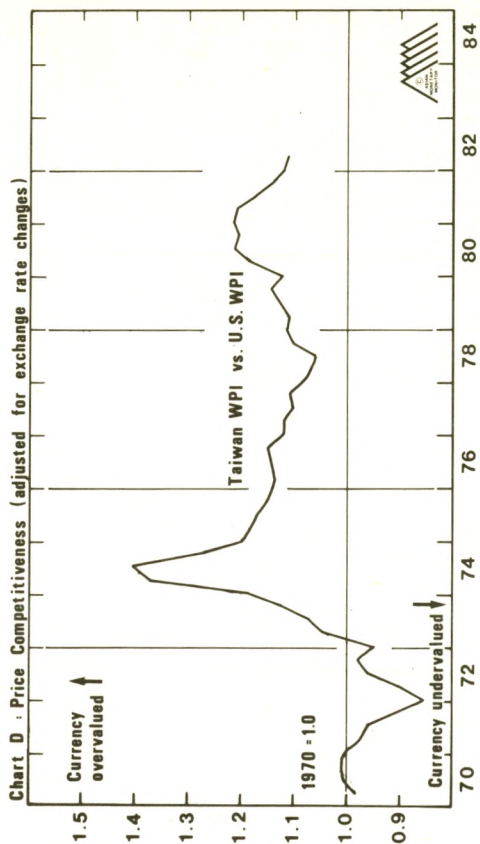
As it is the present downturn has been so sharp that the deflationary process has already started to produce a dramatic improvement in the external accounts (Chart B). For although exports have slowed, imports have slowed even faster, and consequently the balance of trade has improved markedly since early 1981. If the American economy were now to turn upwards, it would surely not be long before Taiwan was off to the inflationary races again.

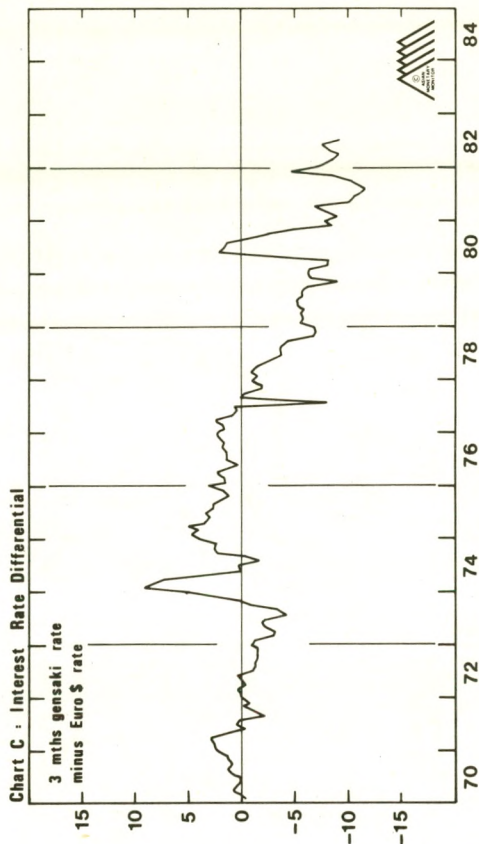
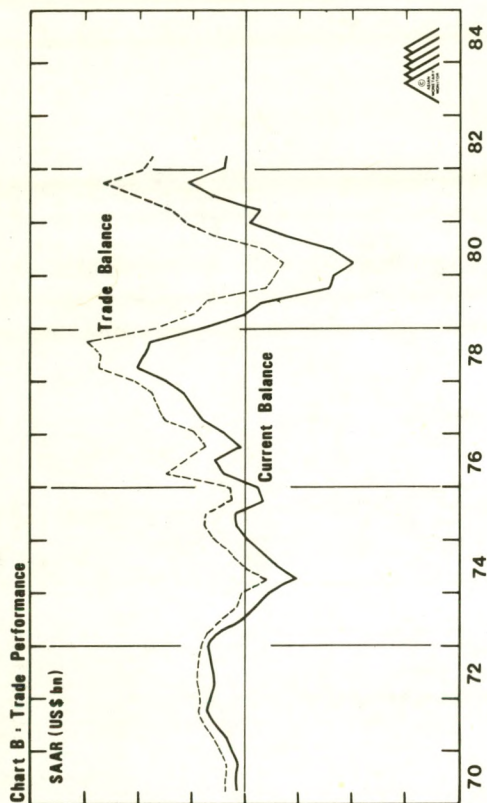
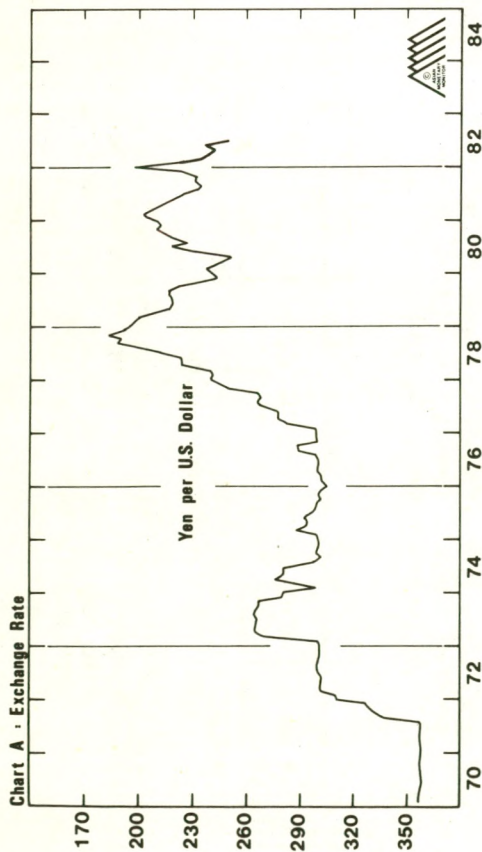
In this case the NT\$ would rapidly start to look like a strong currency again, and upward pressure on the rate would intensify as balance of payments surpluses persisted. At the present time and given the present rather artificial method of adjusting the day-to-day currency value it is likely that Taiwan is close to the trough both in terms of economic activity and in terms of the value of its currency in the current stop-go-stop cycle.

NT\$/US\$	ACTUAL		FORECAST	
	1982 Q1	Apr. - May	Q3	Q4
FORECAST A			39.00	39.00
Actual Range	37.00-38.17	37.00-38.18		
FORECAST B			41.20	41.20

Forecast A is the most likely range in the absence of a major political or external disruption.

Forecast B is based on a simple projection of relative price competitiveness depicted in Chart D i.e. the exchange rate required to bring US and local price levels approximately into line.





The decline in the yen-dollar exchange rate since the end of 1981 reflects both a more restrictive monetary policy by the US Federal Reserve - bringing with it a concomitant rise in US short interest rates - and weakening domestic influences on the yen.

Chart C illustrates the adverse trend in nominal interest rate differentials which have been an important factor behind the yen's weakness. Eurodollar interest rates have risen from 12% to 16%, since the start of the year and there are widespread expectations of further increases into the second half of 1982. Real interest rate differentials have also favoured the dollar, where inflation adjusted yields of 7% or 8% are available on many short term money market assets, in comparison to the 4% real return on short-dated yen securities. Nevertheless the trend in interest rates has not always proved an entirely reliable guide to movements in the yen-dollar exchange rate. The periods between mid 1977 and October 1978, and again in the second half of 1980 are examples of times where the yen strengthened in spite of an apparently adverse trend in domestic and US rates. However during those periods the yen was supported both by the Bank of Japan's restrictive monetary policy and a strong improvement in Japan's current account. However it is clear from Charts B and E that the latest rise in US interest rates has occurred

at a time when the Bank of Japan's monetary policy has been relatively 'easy' and when Japan's trade surplus has been declining.

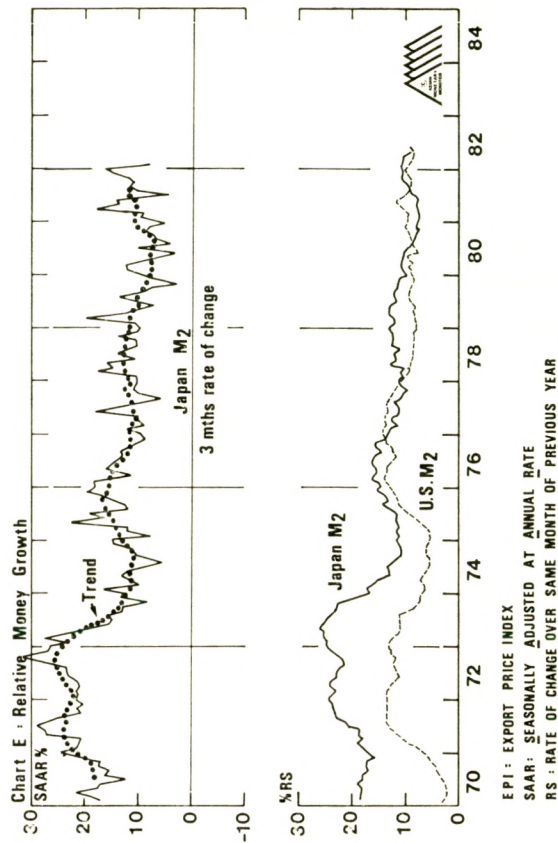
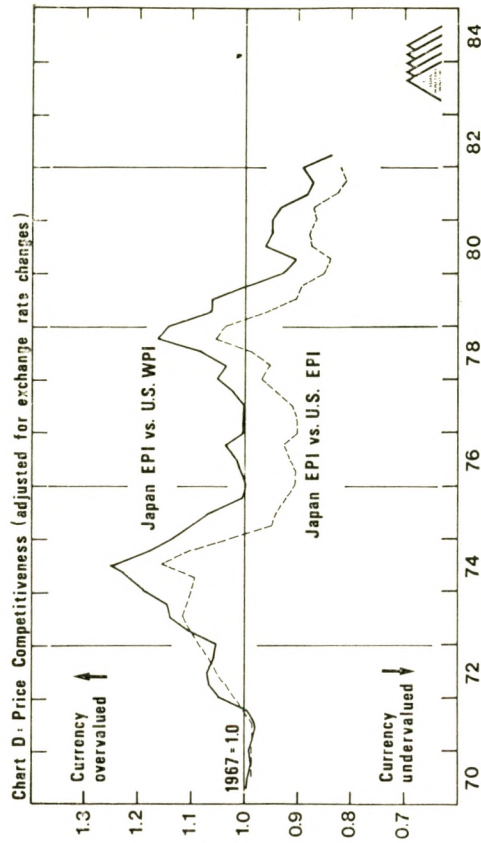
The Bank of Japan has been one of the only major Central Banks to follow a relatively stimulative monetary policy during the past year. M2+CD growth rose steadily during 1981 and has averaged around 10%, on a yearly basis, since the third quarter of 1981. The Bank of Japan's efforts to encourage easier liquidity growth whilst the Federal Reserve has pursued a generally restrictive monetary stance have been an important factor behind the weakness of the yen. The decline in the trade surplus evident since the third quarter of 1981 is likely to continue. Japanese export growth is at its lowest rate since 1975 and in spite of the fact that the yen is considerably undervalued in terms of price competitiveness (see Chart D), continued economic weakness overseas implies that an increase in the demand for Japanese exports may be delayed until 1983. Japanese imports, however, have been relatively stable over the past year and seem likely to rise along with a moderate recovery in the domestic economy.

Whilst the cyclical position of the Japanese economy suggests that the yen will remain relatively weak against the US dollar, it should be noted that the scope for changes in Central Bank policy tend to favour a stronger yen. Specifically, it seems that monetary growth in Japan has peaked and, with Japanese short-term rates rising, additional ease by the Bank of Japan is unlikely. At the same time, the potential for a more accommodative policy by the Federal Reserve in the US is rising. As noted above, the yen is considerably undervalued and could strengthen markedly once the Federal Reserve eases its stance.

Yen/US\$	1982 Q1	Apr.-May	FORECAST	
			Q3	Q4
FORECAST A	218.90-247.70	232.35-248.60	245-265	245-265
Actual Range FORECAST B			235-250	225-240

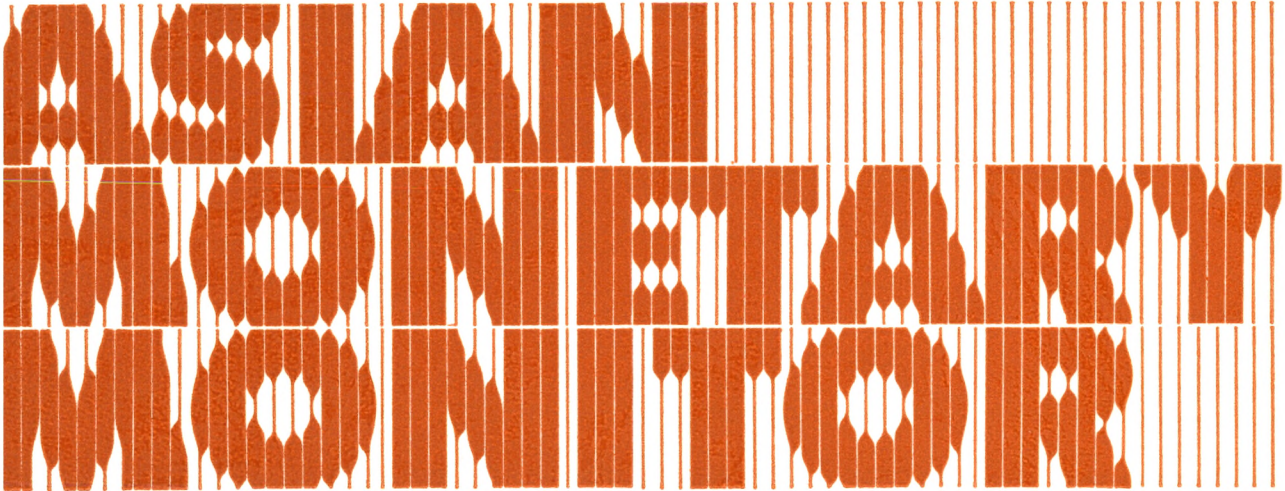
Forecast A assumes no reduction in the level of US interest rates in the remainder of 1982.

Forecast B assumes that the combination of a relatively weak economy and lower monetary growth allows US short rates to decline during the second half of 1982.





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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of
preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

REGIONAL SURVEY

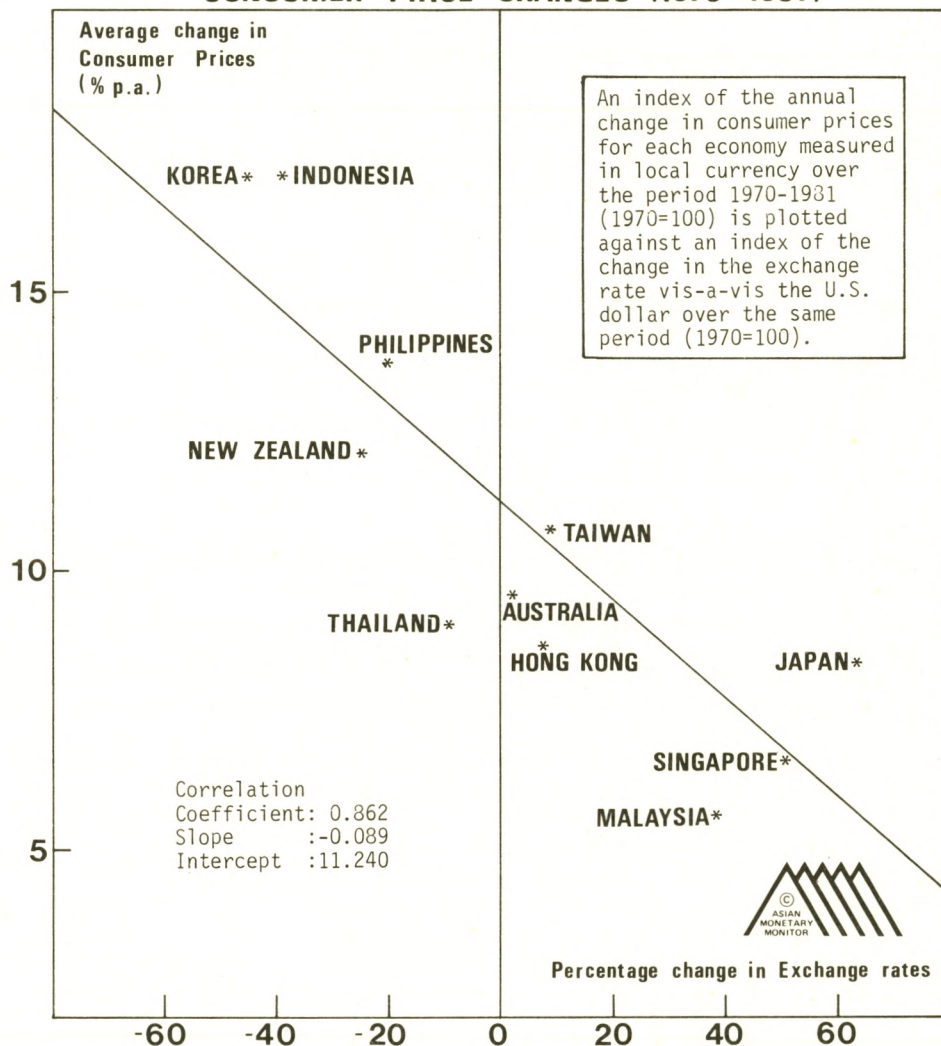
INFLATION, EXCHANGE RATES AND MONEY GROWTH IN THE EAST ASIAN PACIFIC RIM (1970 - 1981)

A Government has two alternatives when formulating exchange rate policies. It can either fix its currency to another currency (e.g. the US dollar) or it may allow its currency to float, with movements dependent up on market forces. Floating currencies come under two categories: a free float (no government intervention), or a managed float (limited government intervention).

One of the major implications for a country fixing its exchange rate against another currency is that the inflation rates in the two countries become closely linked together. The following example explains this mechanism. The currency of country A is pegged to the currency of country B. Assume that at the beginning of the period the balance of payments was in equilibrium and that inflation rates were similar. Let us say that, for political motives, country B decided to increase its money supply and reflate the economy. This would have two effects. Firstly domestic demand in B would pick up, and secondly B would experience a higher inflation rate (caused by the more rapid monetary growth) some time later. The effects of country B's new policy on country A are twofold. Firstly demand for A's exports would increase and secondly, some time later demand in country A for exports of country B would fall because of their higher prices and reduced competitiveness. So A's exports increase while A's imports decrease. As a result of this country A's balance of payments will move into surplus. As a consequence of the central bank absorbing this surplus, reserves in A's banks will increase, expanding the monetary base, which leads to higher monetary growth. This higher monetary growth will lead to higher demand for imports and, some time later, as a result of higher inflation, lower exports. The higher imports and lower exports will return A's balance of payments towards equilibrium.

In the long run A will tend to experience a balance of payments surplus whenever its price level is cheap or competitive relative to B's price level, and conversely a balance of payments deficit whenever A's price level is high or uncompetitive relative to B's. Since the balance of payments dictates the money supply which in turn determines the level of inflation, we can see that, under such a fixed exchange rate system A's inflation rate will be tied to B's over the longer term. The time lag between money growth and inflation inevitably means there will be short term differences, but the system works in such a way as to cause the money supply in country A to continue either to expand or to contract until the balance of payments is brought into equilibrium - a condition which only occurs when the price levels in the two countries are in line with one another.

CHART 1
THE RELATIONSHIP BETWEEN EXCHANGE RATES AND
CONSUMER PRICE CHANGES (1970-1981)



However, if a country pursues a floating exchange rate policy it will not encounter this problem of swinging from balance of payments surplus to deficit and back again. With floating exchange rates the balance of payments will tend to zero. This is because any tendency for the balance of payments to move into surplus will cause the currency to appreciate and, due to rising imports and falling exports, the balance of payments will return to equilibrium. Conversely, any tendency for the balance of payments to move into deficit will cause the currency to depreciate and, due to rising exports and falling imports, the balance of payments will again return to equilibrium.

In contrast to a fixed exchange rate system, the banks in a floating exchange rate country will not be subject to large reserve injections or withdrawals and the monetary base will remain unaffected by external forces. Thus countries operating a floating exchange rate do not incur the problem of monetary growth outside of their control. The only determinant of inflation is the domestically controlled money growth.

Chart 1 illustrates the relationship between inflation and exchange rates for 11 countries in the Far East. As one would expect, the countries with higher inflation have had weaker currencies and countries with lower inflation have had stronger currencies over the period 1970-81. The important point to note here is that the relationship holds irrespective of whether the currency is operating a fixed or a floating exchange rate. However, the correlation factor is only 0.862. What explanation might there be for such a wide dispersion?

In the first place, the time lag between excessive monetary growth and the resulting inflation varies both from country to country and over different periods within the same country. Therefore inter-country comparisons will reflect these discrepancies. Second, methods of measuring the CPI differ in composition and accuracy from country to country. Finally, the dates chosen for the starting and finishing points for this study are quite arbitrary, and the particular exchange rates at these dates were not necessarily equilibrium exchange rates. The conclusion one can draw from the chart is that, although currencies and inflation rates tend towards the trend line (which represents the average Purchasing Power Parity), they can deviate widely from the norm for significant periods of time, due for example to factors of a non-market nature which may affect the exchange rate (e.g. confidence) or factors which may affect prices (e.g. wage/price controls).

While the relation between exchange rates and inflation appears to be a good one, both currency values and price levels are in turn symptoms of the relation between monetary growth and inflation. The remaining six charts are devoted to exploring the link between monetary growth and inflation for the same 11 Asian economies over the same time period (1970-81).

Charts 2 and 3 illustrate the relationship between the rate of increase of consumer prices (on the vertical axis) and

CHART 2
MONEY SUPPLY AND INFLATION IN THE EAST ASIAN PACIFIC RIM (1970-81)

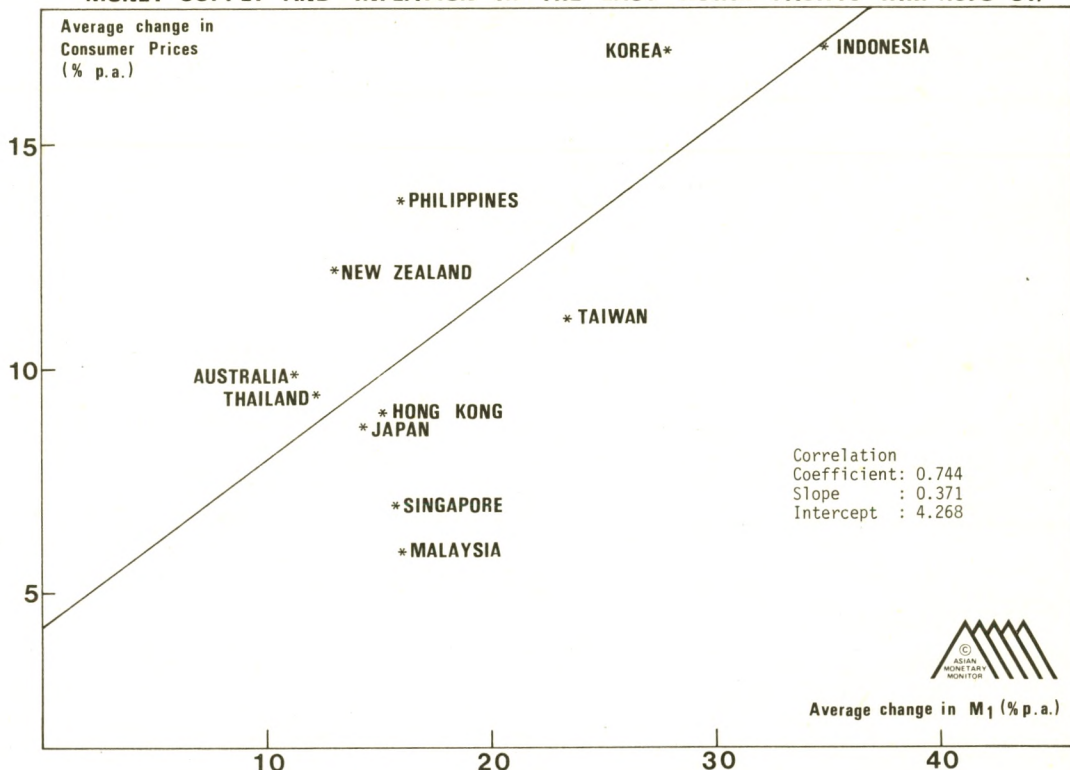


CHART 3

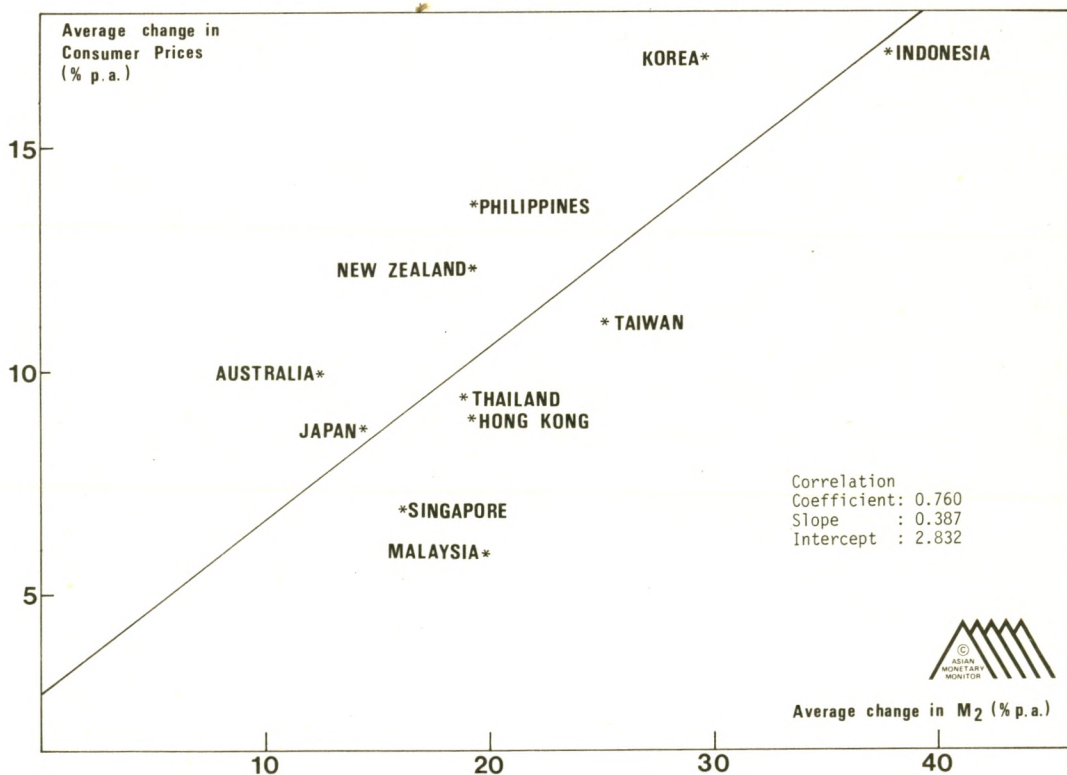


CHART 4

MONEY SUPPLY (ADJUSTED FOR REAL ECONOMIC GROWTH) AND INFLATION IN THE EAST ASIAN PACIFIC RIM (1970-81)

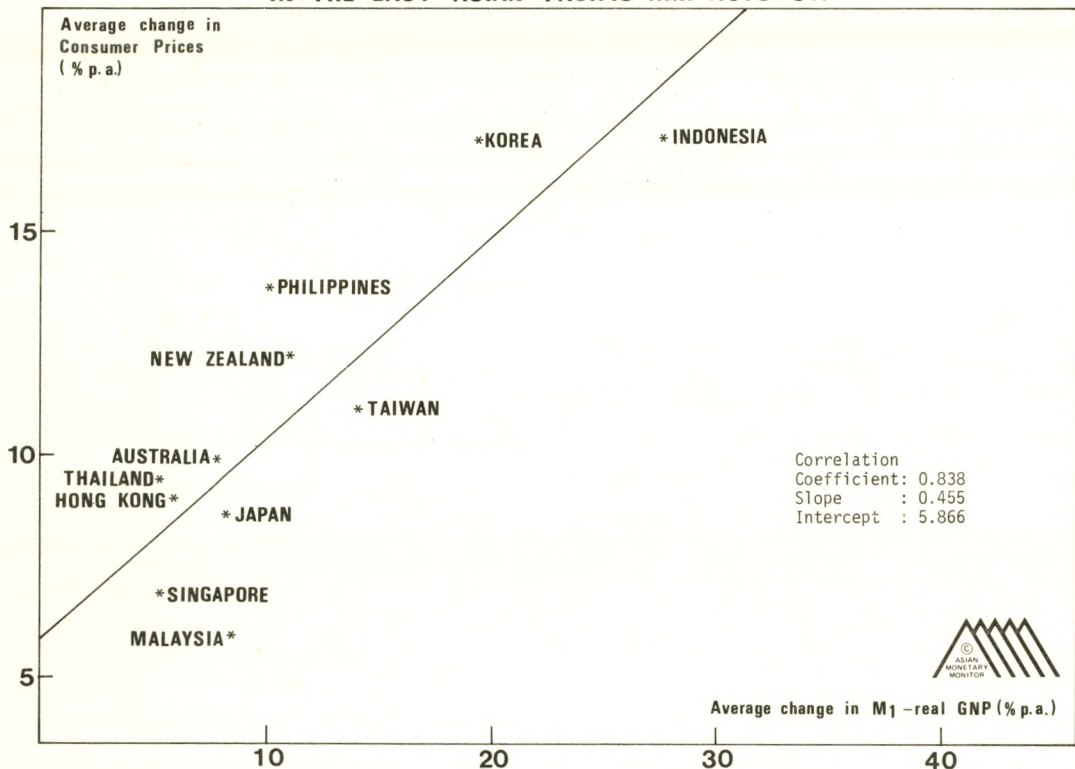
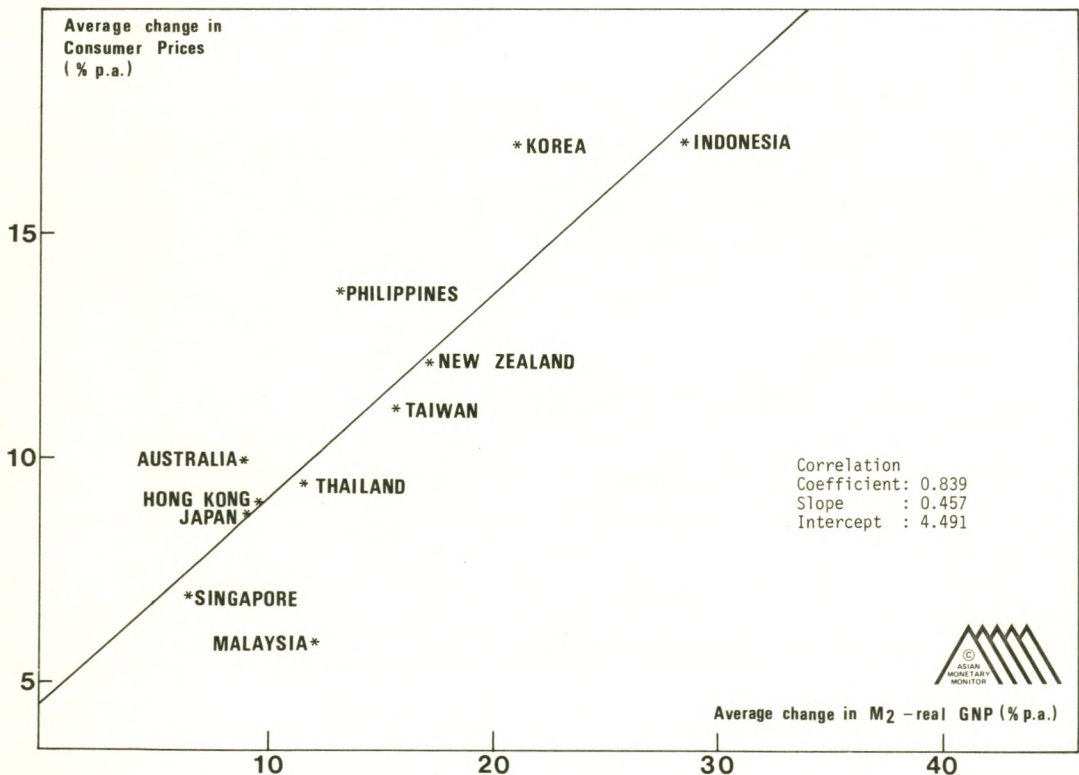


CHART 5



the rates of growth of M1 and M2 (on the horizontal axis) respectively. Although the correlation coefficients are low (0.760 and 0.744) one can see that some correlation does exist. This is the crudest indicator that monetary growth is associated with inflation. However, not all monetary growth is necessarily inflationary.

How does one decide what proportion of monetary growth is excessive, or inflationary? The higher level of transactions associated with economic growth will absorb some monetary growth so the first stage of refining the relationship is to subtract real GNP growth from M1 and M2 growth. Charts 4 and 5 compare consumer prices with (M1 - real GNP) and (M2 - real GNP) respectively (all in terms of year-to-year rates of change). Immediately one can see the relationship is better. The correlation coefficients leap from 0.760 and 0.744 to 0.839 and 0.838.

Even though the correlations are better, they are still not entirely satisfactory. However, the ratio of money to nominal GNP, or Marshall K, may provide a clue. The experience in rapidly growing countries is that individuals accumulate money relative to their annual income. Malaysia is a good example. Malaysian Marshall K rose on average 5.5% p.a. over the period 1970-81. Thus while it would appear that Malaysia should have experienced 12% p.a. inflation over the 1970-81 period (M2 - real GNP equals 12%) the inflation rate was actually only 4.9% with most of the remaining 6.1% being taken up by larger holdings of money relative to income i.e. the change in Marshall K.

Charts 6 and 7 show consumer prices plotted against M1 minus (real GNP + Marshall K) and M2 minus (real GNP + Marshall K) - again in terms of average rates of change over a year. The correlation coefficients again improve to 0.935 and 0.953. Thus it appears that to provide a good explanation for the different rates of inflation in our 11 Asian economies it is not sufficient to look only at the growth rates of money supply. A better explanation is provided by adjusting money supply growth for real economic growth, and an even better explanation is obtained by making a further adjustment for the observed build-up of money balances relative to income as people get richer - at least at the current stage of economic development.

Students of monetary theory will recognise in these steps the various elements of the well-known modern quantity theory of money which states that the level of prices in any economy is determined by the stock of money, the level of real income and the amount of money held by individuals in relation to their income. Expressed in terms of rates of change, the theory says that the inflation rate is determined by the money growth rate, the growth rate of real incomes (or real GNP), and the rate at which money balances are accumulated in relation to income. Since the final item in this chain of determinants is defined in terms of the other components of the quantity equation (money and nominal income i.e. real income times the price level), changes in Marshall K

CHART 6
MONEY SUPPLY (ADJUSTED FOR REAL ECONOMIC GROWTH AND THE MARSHALL K EFFECT) AND INFLATION IN THE EAST ASIAN PACIFIC RIM (1970-81)

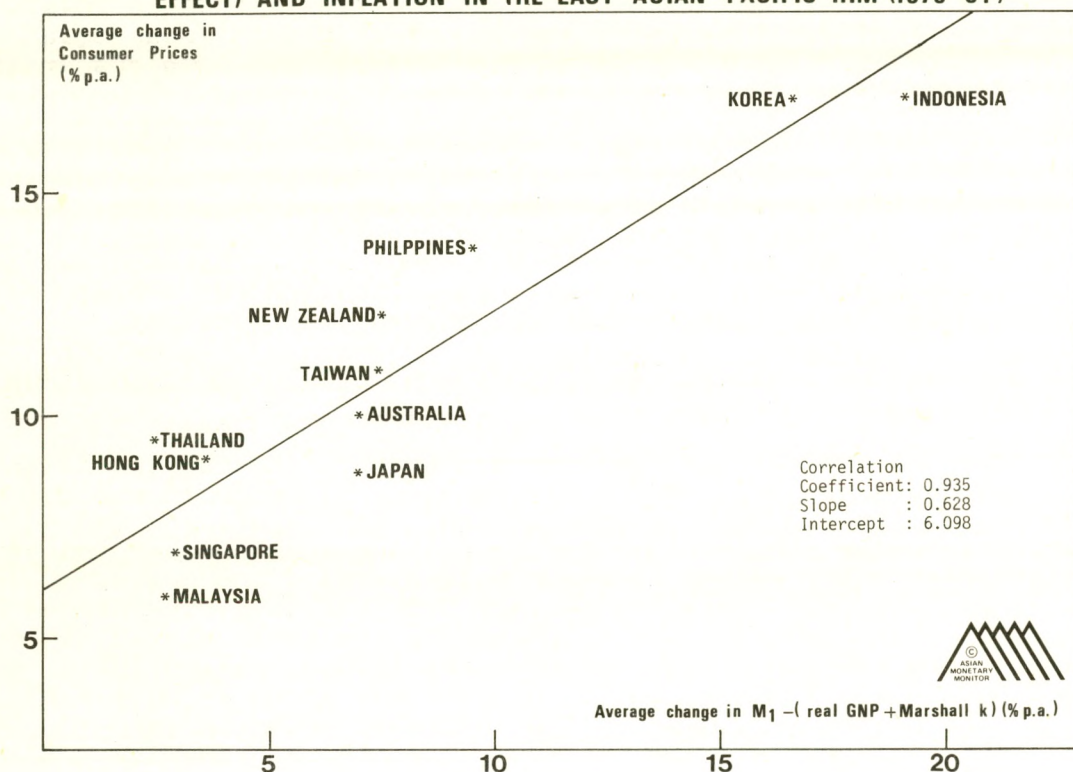
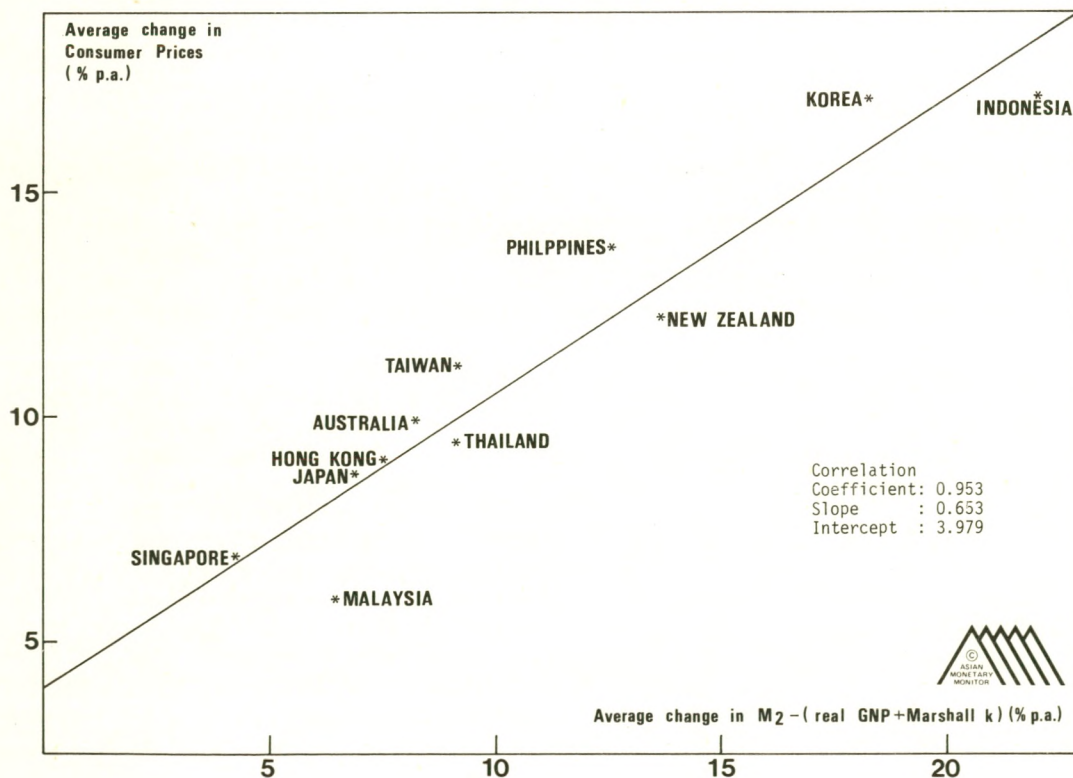


CHART 7

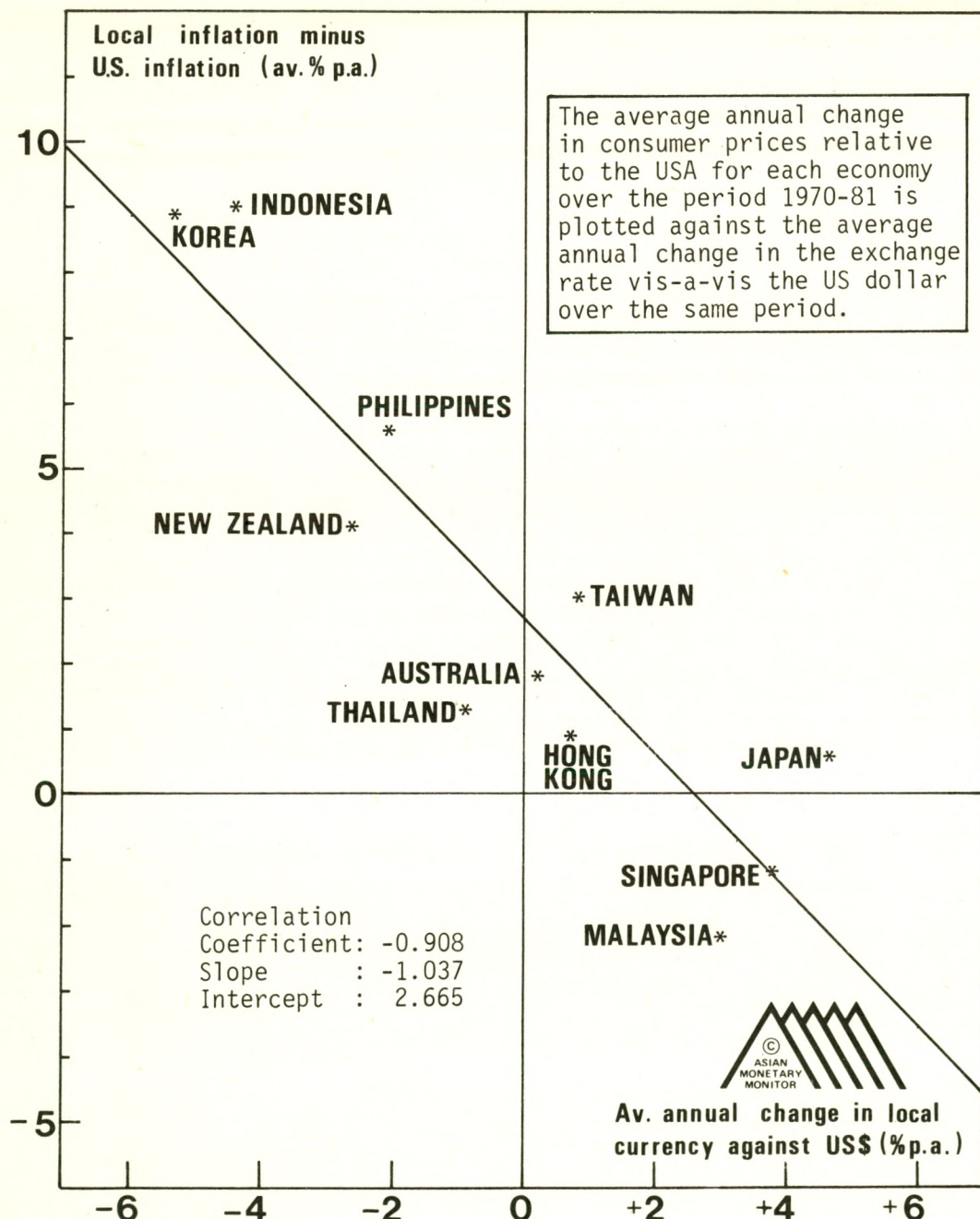


necessarily equate differences in the growth rates of money and nominal income. It follows that the correlation between price changes and money growth less real income and Marshall K should be perfect (unity). The reason that it is not unity in our charts is that we have used the consumer price index as a measure of inflation rather than the GNP deflator which is the most appropriate indicator of the price level from the standpoint of theory.

CONCLUSION: Irrespective of whether Asian governments have opted for fixed or managed or freely floating exchange rates in the period 1970-81, the appreciation or depreciation in their exchange rates against the US dollar is well explained by their underlying inflation rate over the decade. Further, their individual inflation rates are well explained by their individual relative rates of money growth, and, with adjustments for real income growth and for the Marshall K effect, further improvements in the correlation coefficients can be obtained. It follows that if a government wishes to prevent inflation it must either peg its currency firmly to the currency of a country which itself has a low inflation rate, or it must manage its exchange rate so as to produce only a small balance of payments surplus and a correspondingly moderate rate of money growth, or it must float its currency but simultaneously control the rate of monetary growth. The appropriate rate of money growth for zero inflation is equal to the real economic growth rate plus whatever is required for the Marshall K effect. Money growth significantly in excess of this amount for a sustained period of time will show up in the form of higher inflation, regardless of the particular exchange rate regime in operation.

SINGAPORE : CHART 1

RELATIVE INFLATION RATES AND CURRENCY APPRECIATION OR DEPRECIATION AGAINST THE US\$ (1970-81)



SINGAPORE

THE DEBATE ON MANAGING THE EXCHANGE RATE AND MANAGING THE INTERNATIONAL RESERVES

Following the management upheavals of the past 16 months since Dr. Goh Keng Swee was appointed Chairman of the Monetary Authority of Singapore, some intensive soul-searching has been going on in the MAS about the policies previously in force, and in March 1981 a whole new organization, the Government of Singapore Investment Corporation (GSIC), was established to manage the assets traditionally managed by the MAS. Two areas of policy appear to have been at centre-stage: (i) the gradual upward adjustment of the Singapore dollar against most other currencies over the past decade since the world moved to more flexible exchange rates, and (ii) the management of Singapore's external currency reserves.

Economic analysis has something to say on each of these subjects without prejudice or partiality towards either the previous policy-makers at the MAS or the present incumbents. Although it is still too early to make any judgments on the implementation of policy under the new regime of Dr. Goh, it is now possible to make some preliminary judgments on the wisdom or otherwise of the policies implemented under his predecessor Dr. Michael Wong Pak-shong. No matter what one's political standpoint may be, some of the achievements of Dr. Wong and his team at the MAS are frozen for all time into the statistical record, and it is upon these data that one must rely for a snapshot view of the opening decade of managed exchange rates.

The big question which is being debated in policy circles and studied by academics in Singapore today is, Has the appreciation of the Singapore dollar damaged Singapore's export performance?

Over the decade from 1970-81 the Singapore dollar appreciated by 51.1% (or 3.8% p.a. at a compound rate) against the U.S. dollar. Among Asian currencies, as Singaporeans know well, the Singapore dollar has the reputation of being the Swiss Franc of the Far East. It has in fact been the second strongest currency in Asia after the yen over the period 1970-81.

If one examines the experience of 11 different Asian currencies over the decade - including all the ASEAN countries - there is a wide range of performance over the decade. In contrast with the Japanese yen and the Singapore dollar which had both generally strengthened (by 4.6% p.a. and 3.8% p.a. respectively) through the decade, the currency of S. Korea depreciated by 5.4% p.a., while the Indonesian Rupiah depreciated by 4.5% p.a. However, there is a most striking relation between the strength of a currency and its average inflation rate over the period (Chart 1). The stronger the currency, the lower the inflation rate; and the weaker the currency, the higher the inflation rate. In fact the slope of the line (-1.037) in Chart 1 suggests that for every annual percentage appreciation in the exchange rate, the inflation

rate will be - on average - one percent lower. The implication is that by keeping the Singapore currency strong against the US\$ the MAS managed to keep the inflation rate in Singapore lower than inflation in the U.S.A. It follows that if the new policy makers in Singapore were deliberately to choose to allow the currency to weaken persistently against the US\$, the inflation rate would inevitably rise and over a sustained period of time Singapore would slip from the lower right of the chart to the upper left.

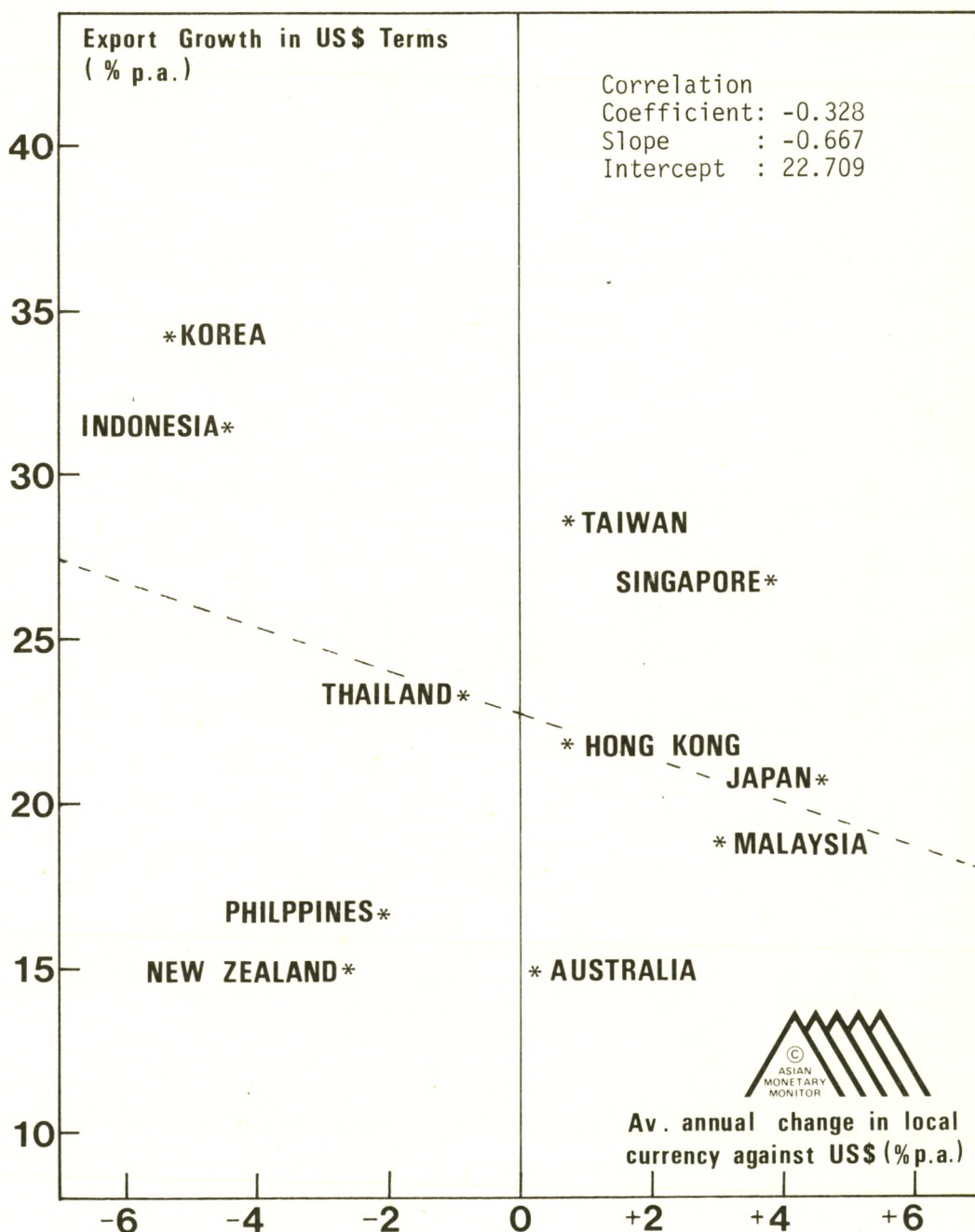
But what impact has the appreciation of the S\$ had on Singapore's exports?

As Chart 2 shows, there is only very low correlation between the rate of growth of Asian countries' exports and their exchange rate policy. Looking first at those countries with over 20% p.a. export growth, South Korea and Indonesia - which have enjoyed the fastest rates of export growth during the period 1970-81 - have also had the weakest currencies in the region, but Japan and Singapore, both with strong currencies, also enjoyed rapid export growth. On the other side, a weak currency does not appear to have helped the Philippines or New Zealand to achieve a particularly distinguished export performance, while Malaysian exports have done better than the Philippines or New Zealand despite having the supposed disadvantage of a steady appreciation of the Malaysian Ringgit. Yet one clear implication of the policy review currently being conducted by the MAS is that if the S\$ exchange were allowed to weaken, might not Singapore's export performance be improved? There has been concern in some circles that the S\$ rate has been "too strong", and that somehow the city state's competitiveness has suffered as a result. However, it should be clearly recognised by those who advocate steering the currency downwards, that while there might be some temporarily stimulative effect on exports, this would in time be offset by rising prices and wages which would ultimately undermine any competitive edge achieved by the initial currency depreciation, causing exports to slow down again. Thus the net effect would be to leave the economy with a higher rate of inflation and a weaker currency, with no net boost to exports.

This argument clearly implies that by deliberately managing the value of the S\$ upwards the MAS (a) did not prejudice the export-achievement of Singapore's major industries and services, and (b) served the island republic well by keeping the inflation rate low for most of the period since the first oil crisis. But the record of macro-economic management is not without blemish: the attempt to keep interest rates down in late 1979 led directly to the monetary acceleration in the final quarter of 1979 and in 1980, and this in turn fuelled the property and stockmarket boom of the following two years. (See AMM May-June 1980 Vol. 4 No. 3 "Monetary Restraint Abandoned" for details of this episode.) Nevertheless, by comparison with most other countries the record of monetary management and the low average rate of inflation achieved over the years 1975-1981 are largely due to the wise policies pursued by Mr. Wong Pak-Shong and his managers, the most crucial being the gradual

SINGAPORE : CHART 2

RELATIVE EXPORT GROWTH AND CURRENCY APPRECIATION OR DEPRECIATION AGAINST THE US\$ (1970-81)



upward adjustment of the S\$ throughout this period. As an example to other countries of the East Asian Pacific Rim, and more generally to all those smaller countries which are attempting to manage their exchange rates as a means of stabilising the domestic economy, the Singaporean example over these years is one to be studied and - for the most part - admired. This is not to imply that other aspects of the Singapore government's policy were all in order, but in the fight against inflation, and in preserving of the value of the currency which is the essential role of any monetary authority, on the whole the MAS under Dr. Wong Pak-Shong succeeded much better than other monetary authorities.

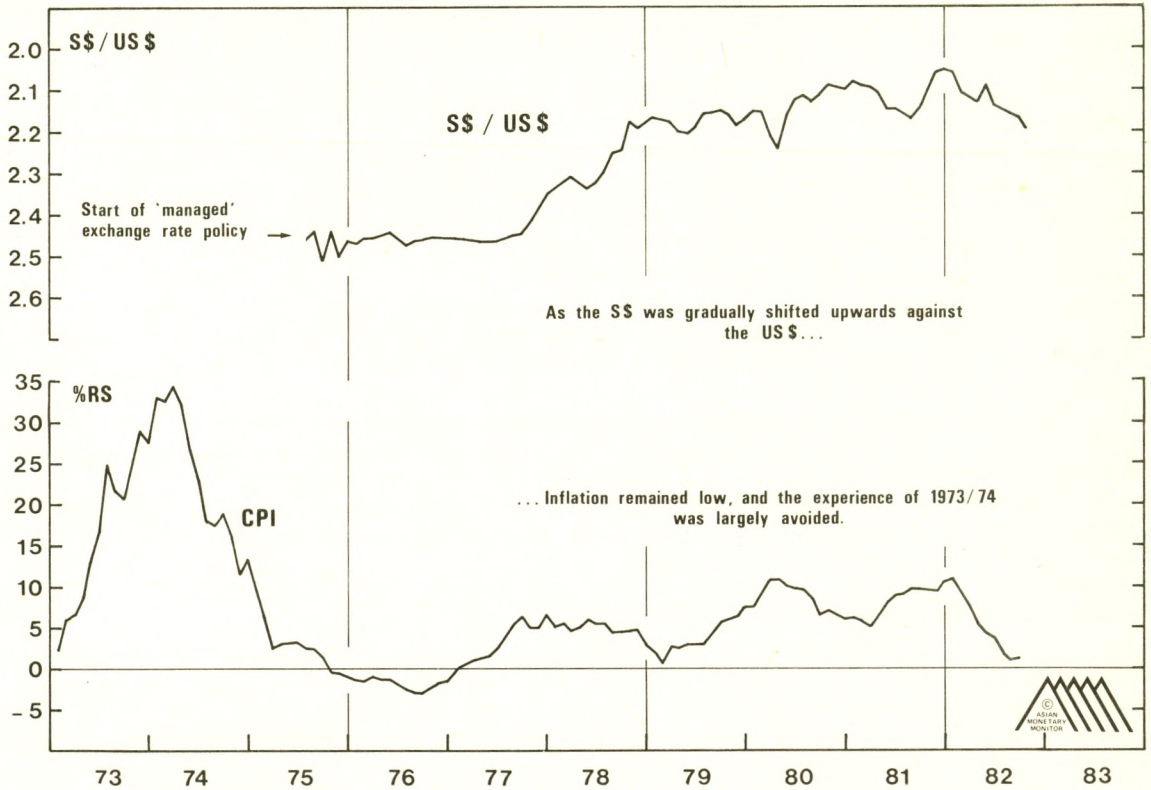
Turning to the second area of MAS policies which have come under scrutiny by the new Chairman Dr. Goh, namely the management of the country's foreign exchange reserves, it is necessary first of all to distinguish between the monetary authorities in their monetary role and the monetary authorities in their role as a guardian of taxpayers' funds. In its monetary role, the essential function of a central bank is to stabilise the value i.e. the domestic purchasing power of the currency. This is not a profit-maximizing function, and depends for success primarily on controlling the monetary growth rate within moderate ranges. All monetary authorities make "profits" (known as seignorage) from the difference between the cost of issuing currency and the interest earned on their assets, but any central banker who implies that profits achieved via the central banking function per se ought to be maximized is on dangerous ground.

A couple of examples will serve to illustrate this proposition. Take the case of a monetary authority which buys fixed interest securities or money market instruments (government or private sector) in the domestic money market. The more securities it buys, the more reserves will be supplied to the banking system, and the more aggressive banks will become in their lending, and the further interest rates will fall. Initially it will appear that the central bank has made a handsome profit on the securities. However, the lower level of interest rates and the more rapid rate of money growth resulting from the open market purchases will generally result in a weaker currency. Since the aggregate money supply is substantially larger than the size of the central bank balance sheet, the welfare loss to the community as a whole will far exceed the monetary gains to the authorities, and this is without taking account of inflation and any resulting consequences to the economy as a whole.

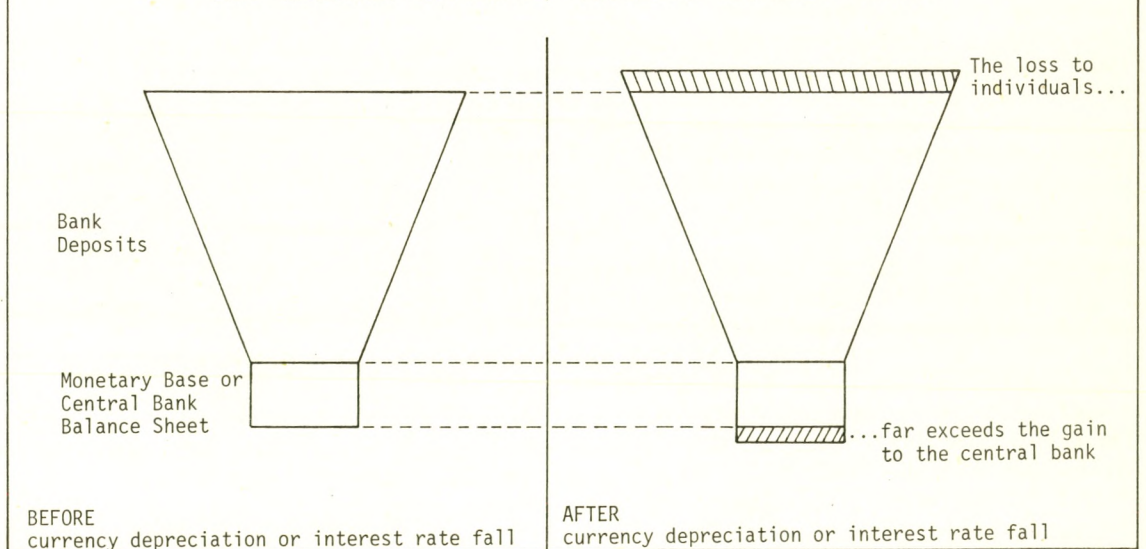
An alternative case is the situation where a central bank, holding mainly foreign-currency assets, deliberately allows the domestic currency to depreciate, and records the gain in value on its foreign portfolio as a profit in domestic currency terms. Again, the welfare loss to the community as a whole considerably exceeds the gain to the central bank. Both of these cases illustrate why it is that central banks, in their monetary role, should not try to maximize profits from their normal open market operations or from their management of the

SINGAPORE

CHART 3 : CURRENCY AND INFLATION



WHY MONETARY AUTHORITIES SHOULDN'T MAXIMIZE PROFITS



exchange rate. It is easy enough to make profits in these ways, but by doing so they will end up jeopardising the monetary stability - and the price stability - of the economy as a whole.

Even if central banks were to make profits on the foreign asset portfolios, what could they do with the profit? It could either be transferred to the overseas assets of the government, or it could be repatriated. If it is transferred, it could be used to purchase goods and services overseas. If it is repatriated by the central bank and converted to domestic currency this would amount to a sale of foreign exchange by the monetary authority, a purchase of domestic currency by the monetary authority (from the commercial banks or other domestic holders) and a corresponding reduction in commercial bank reserve deposits at the central bank. To offset the reduction in bank reserves, domestic open market purchases will be necessary. After these operations are completed there is no sense in which the monetary authority or the economy is better off, so it is questionable whether in fact there is any benefit at all in a central bank actively managing its foreign asset portfolio to maximize investment gains.

More fundamentally, the proper job of the monetary authorities is to preserve the purchasing power of the domestic currency. There is no way in which making profits from foreign currency management outside the country can contribute to that end.

In their role as a guardian of taxpayers' funds some central banks or monetary authorities have the responsibility of managing either the profits earned from the sale of the nation's natural resources (e.g. oil, minerals etc.) or the funds collected from tax-payers and wage-earners through national pension or provident schemes. Setting aside the question of the desirability of the monetary authorities or the government performing this function, it is clearly desirable that the returns on these funds should be maximized, but this activity, namely the fiduciary management of private funds, is quite separate from and should be clearly distinguished from the strictly monetary role of a monetary authority in managing the currency.

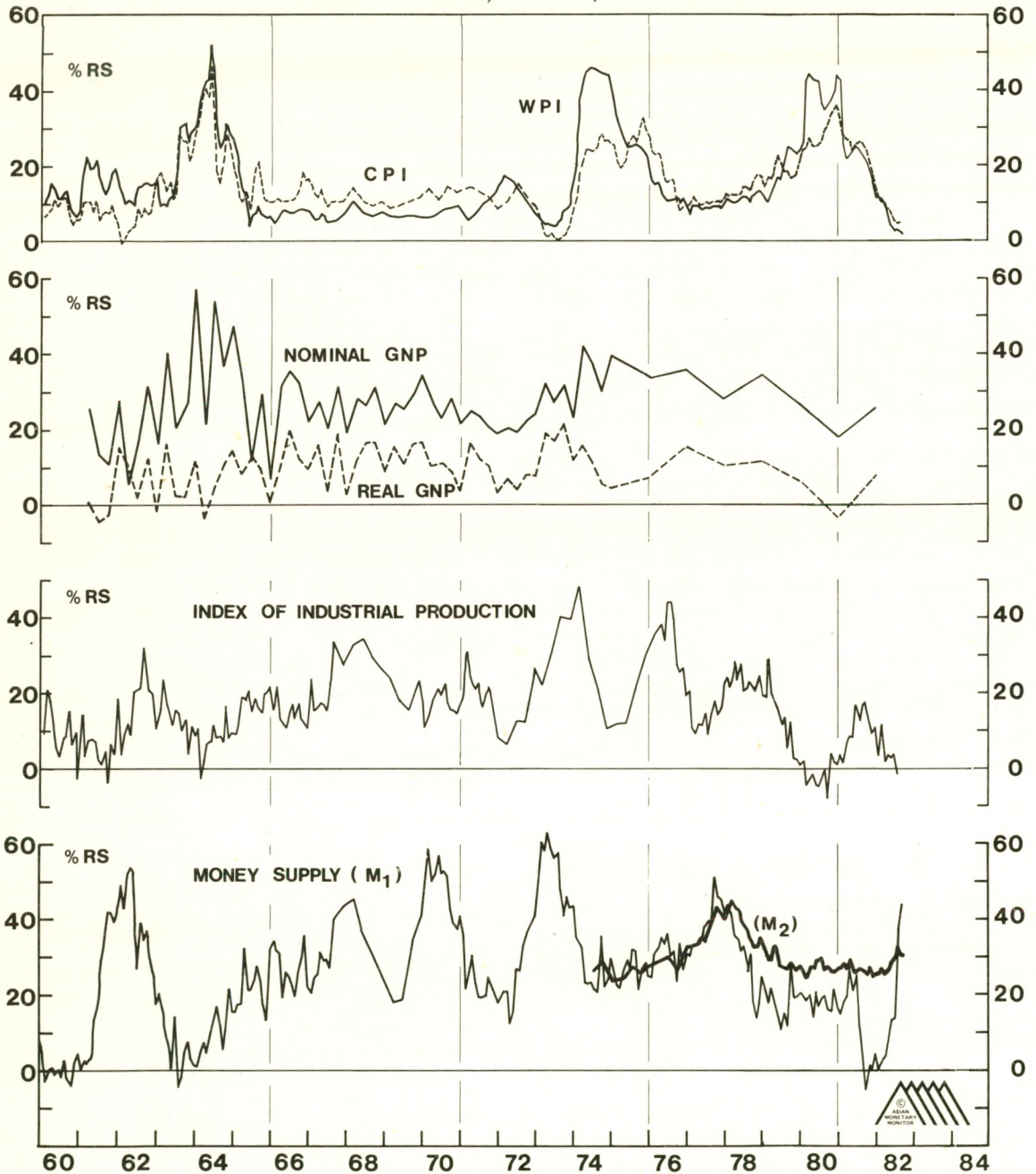
SUMMARY AND CONCLUSION: The management upheavals at the MAS over the past 16 months have prompted a re-examination of some of the key decisions of monetary policy in recent years. The policy of gradually moving the Singapore dollar upwards against the weak U.S. dollar (until 1980) and then maintaining the S\$ roughly stable against the U.S. currency when it strengthened in 1981 has been criticised in several quarters. The previous managers of the MAS have also come in for some criticism of their management of Singapore's foreign assets.

On the question of the management of the currency and the associated management of the domestic money supply, the record of the MAS up until late 1979 was exceptionally creditable, and

then only the attempt to keep interest rates down and/or prevent the exchange rate appreciating too much misled them into allowing an undue monetary expansion which in turn led to the speculative boom on the stock and property markets in 1980-81. Subsequently this led to higher inflation in 1981-82, but that problem should not be exaggerated. Singapore has already seen its inflation rate fall to a mere 2% and the economy is now well-poised to benefit from a recovery in the U.S.A. when it occurs next year.

On the question of foreign asset management, we have shown that there is no benefit - from a monetary management standpoint - in the MAS (or any other central bank or monetary authority) setting out to maximize profits. Quite separately, if the monetary authority is acting in the capacity of a fiduciary manager of taxpayers' funds there is a clear case for a central bank (or indeed any institution charged with that task) trying to maximize the return on those funds, but it is questionable whether a central bank is the appropriate institution to manage such funds. Insofar as the distinction is feasible, there is little benefit in the MAS devoting significant resources to managing its foreign "monetary" assets, but it is worthwhile - indeed, obligatory - that the returns on assets held in trust for taxpayers should be maximized. To clarify the different aspects of these two roles it would be desirable to separate out these two functions. In short, MAS and GSIC (Government of Singapore Investment Corporation) have quite distinct roles, and there would be little benefit in GSIC taking over the monetary assets of the MAS with a view to more active or profit-maximising management.

SOUTH KOREA
CHART 1: MONEY, OUTPUT, AND PRICES



SOUTH KOREA

THE IMPACT OF THE CURB MARKET SCANDAL ON THE BUSINESS CYCLE

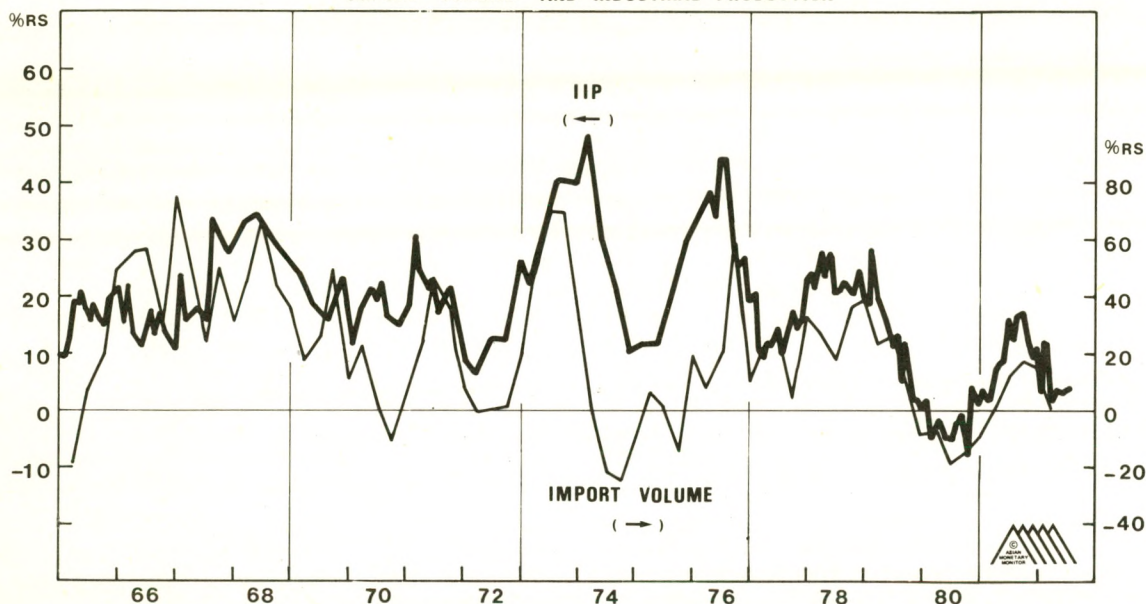
Severe credit crises and associated periods of financial anxiety often mark important turning points in countries' business cycles. The best-known examples of this have occurred in Western economies. The near-bankruptcy of both Chrysler and Lockheed Corporations proved to be the turning point of the 1970 recession in the U.S., and the unexpected failure of Penn Central Corp. and the Franklin National Bank occurred very close to a decisive turn in the 1974 recession. Similarly, the Burmah Oil crisis during the early days of 1975 signalled an approaching trough in the U.K. economy. The fundamental reason why major credit crises are often associated with a cyclical change in the underlying direction of economic activity is that they frequently precipitate an adjustment or reversal in the basic thrust of official economic policy. Alternatively they may be followed by a sharp change in behaviour by bankers who may suddenly become much more guarded in their lending policies, or by businessmen who are likely to scale down their borrowing in the aftermath of a credit crunch. The credit crises in the U.S. during 1970 and 1974 both induced an abandonment of existing monetary restraint by the Federal Reserve. The secondary banking crisis in the U.K. during the summer of 1974 also encouraged an easing of monetary policy by the Bank of England which progressively reduced its Minimum Lending Rate by three percentage points from 12 3/4% in early 1974 to 9 3/4% by April 1975.

During May of this year the Korean economy suffered the worst - and certainly the best documented - financial crisis of its recent economic history. The Curb Market Scandal brought about the bankruptcy of three publicly-quoted Korean companies, challenged the integrity of the Korean Administration, and was swiftly followed by a series of official economic policy adjustments. The most important change in economic management has been in the direction of monetary policy. After more than two years of monetary rectitude, and associated depressed levels of economic activity, the Korean authorities appear to have deliberately eased monetary policy. Thus it seems likely that the Curb Scandal could mark a major turning point in the Korean business cycle, but one which risks rekindling the inflationary fires the Bank of Korea has sought so hard to quench.

In AMM Vol. 6 No. 1 we pointed to the monetarist policies which the Bank of Korea had been experimenting with during 1980 and 1981. In each of these years, the Bank of Korea targeted M2 growth to be 25%. In the event, the BOK came very close to achieving these objectives, with M2 rising by 26.9% during 1980 and 25.8% in the year to December 1981. This performance represented a dramatic reversal of the monetary trends evident during the mid-1970's when M2 growth accelerated from a cyclical low of 23.4% in December 1974 to a high of 45.3% in February 1978. Naturally, the 1980-81 slowdown in monetary

S. KOREA: CHART 2

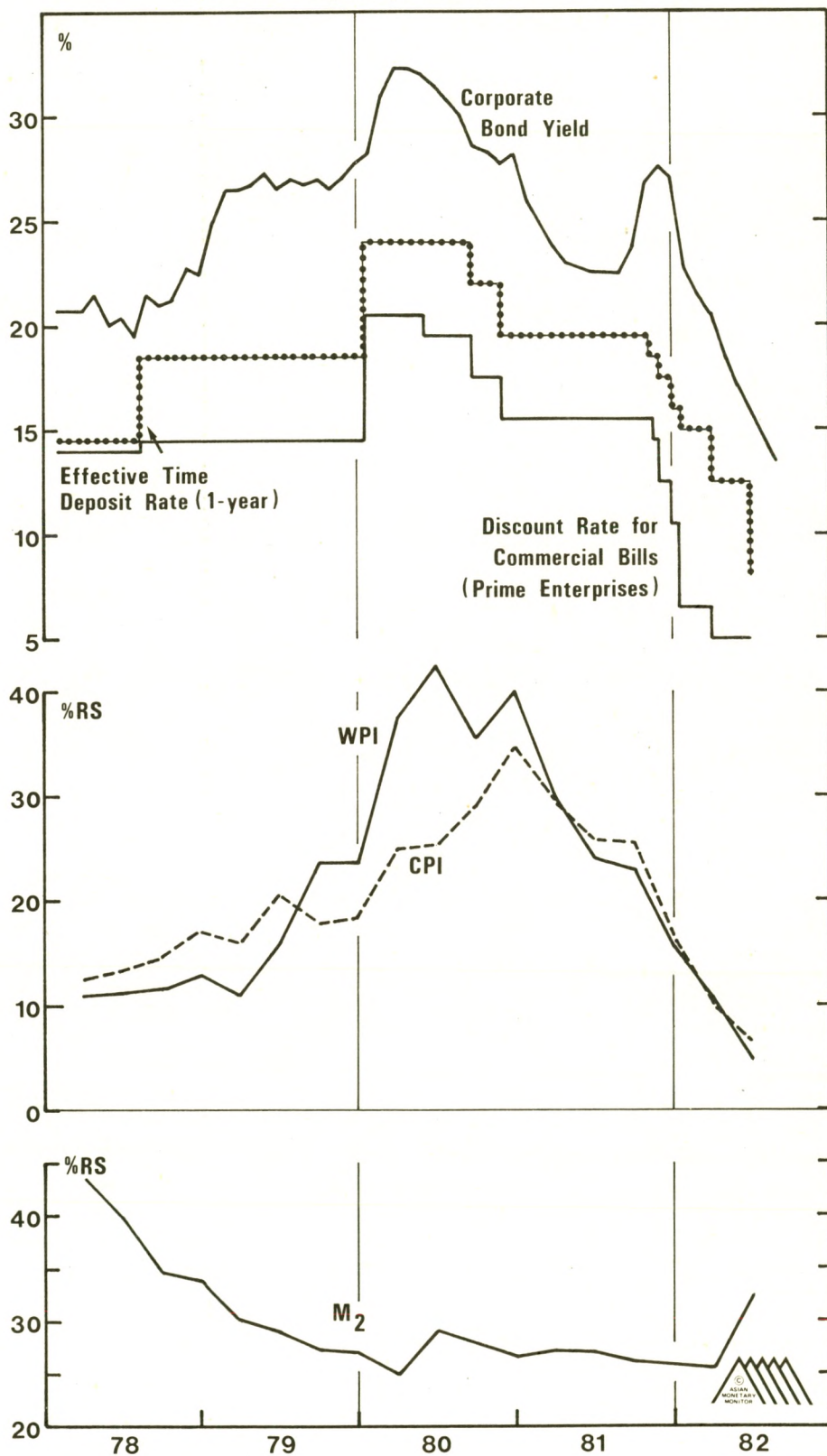
IMPORT VOLUME AND INDUSTRIAL PRODUCTION



growth by the BOK had sizeable repercussions on the domestic economy. The monetary squeeze precipitated the first year-to-year decline in real GNP for two decades (see Chart 1) and industrial production and import volumes (see Chart 2) slumped. These deleterious consequences of a shift towards monetary conservatism are typically relatively short-lived. The benefits of monetary restraint, however, can be more permanent and Korea's experience during the past two years serves as a vivid reminder of the gains that can be made from disinflationary monetary policies. In response to sustained monetary restraint both inflation and the level of interest rates plummeted during the 1980-1981 period. These changes are depicted in Chart 3 which demonstrates the quarterly trend in monetary growth, consumer and wholesale price inflation, and the level of short term and longer term interest rates since the start of 1978.

Chart 3 is also important because it demonstrates the change in Korean monetary policy during the first half of this year. Falling interest rates during the last six months of 1980 and 1981 occurred against the backdrop of monetary growth being within target and consequently reduced inflation. This pattern has not been repeated so far this year. Although the rate of inflation has continued to decline, albeit at a slower pace when compared with 1981, additional reductions in official interest rates have occurred in conjunction with a sharp rise in monetary growth, with the year-to-year growth in M2 accelerating to 34.4% in March, and remaining well above target at 29.3% at the end of June. This leads to the

S. Korea
Chart 3 : Liquidity Indicators and Prices



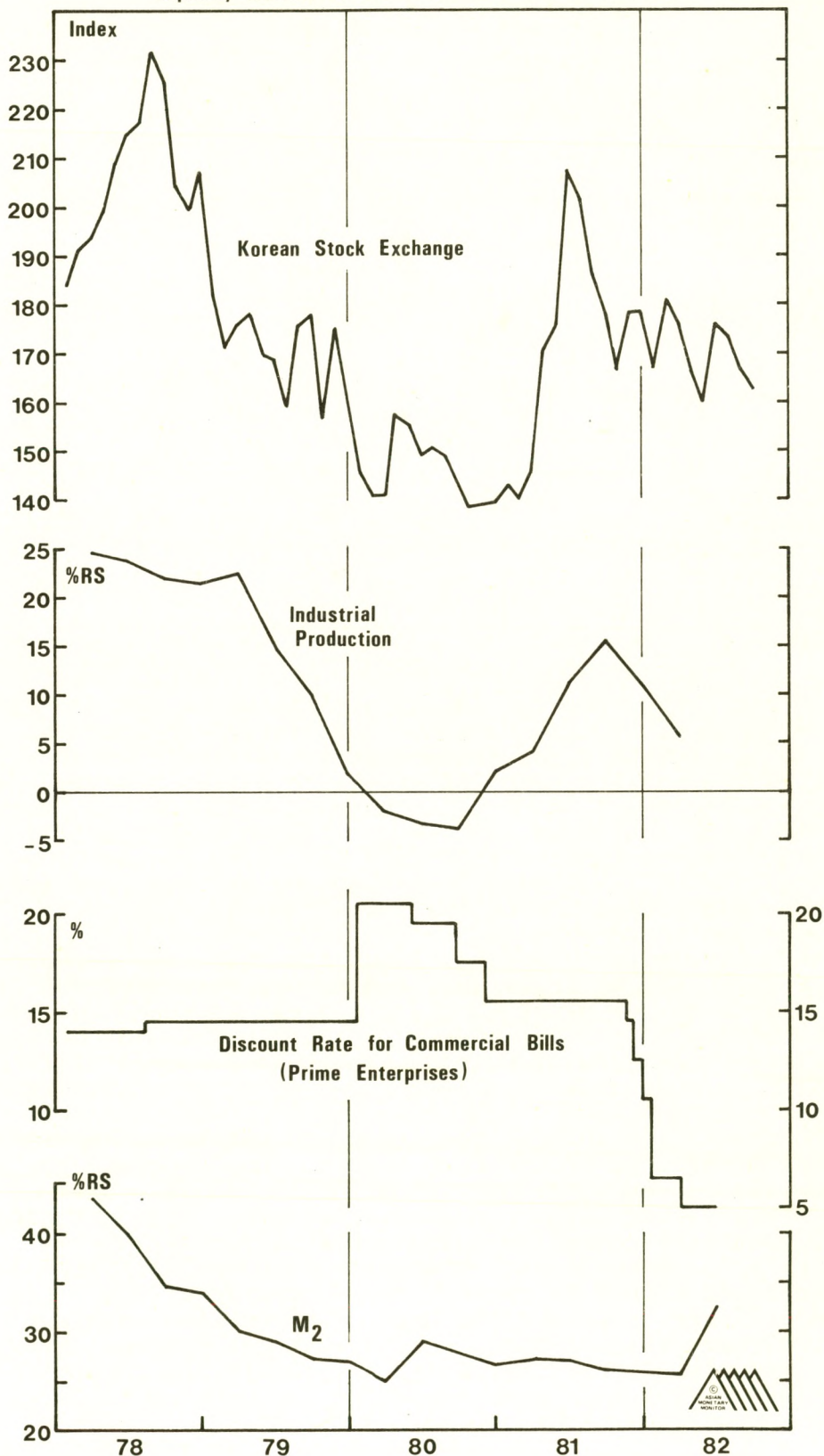
suspicion that the Bank of Korea has deliberately 'pump-primed' monetary growth in order to stimulate the economy.

It is important to note that this process began in advance of the Curb Market Scandal. On January 6th Ha Yeung-ki, the Bank of Korea Governor who succeeded the architect of Korea's new monetary policy, Kim Joong-sung, reaffirmed the Central Bank's commitment to a "hard money" policy. He announced that the target for M2 growth during 1982 had been reduced to 20%-22%, down from 25% during 1981. However, by February of this year M2 was apparently already well above target, with growth exceeding 26% on an annual basis.

Given that the BOK has allowed the Won to float more freely on the foreign exchanges, appropriate policy measures by the Bank of Korea at this stage would have been to raise domestic interest rates in order to rein in above-target monetary growth. However, like many other Central Banks during the past two years, the BOK found itself on the horns of a dilemma; it may well have felt that raising domestic interest rates at that time would exacerbate the deteriorating trend then evident in industrial production (refer to Chart 1). Whilst other Central Banks - notably the Federal Reserve in the U.S. - have generally persevered with a restrictive monetary policy, the BOK apparently decided to ease up. On March 29th, with monetary growth already over target, the BOK announced reductions in a broad range of interest rates: The Official Discount Rate, which had been sliced from 10.5% to 6.5% on January 14th was reduced by a further one and a half percent to 5%, whilst regulated time deposit rates were cut from 15% to 12.6% and bank loan rates reduced by an average of one percent. Lower interest rates contributed to further growth in the monetary aggregates with M2 rising 33.7% in the year to April.

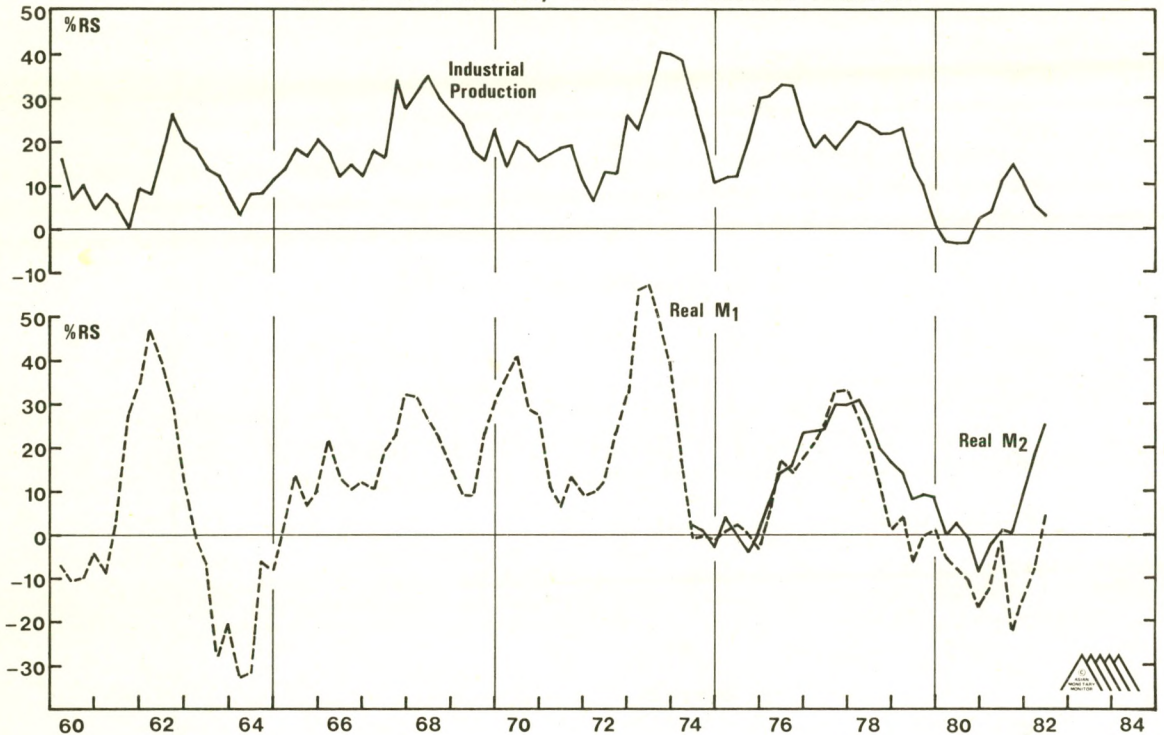
The Curb Market Crisis seems to have further convinced the Korean authorities of the short term expediency of an easier monetary stance. The scandal broke on Thursday May 13th with the announcement that many Korean banks had "dishonored" promissory notes issued by both Ilssin Steel Co. and Kong Yung Construction Co. The promissory notes had been issued as collateral against loans made to these companies, amongst others, by former National Assembly-man Lee Chu-hee and his wife Chang Yong-ja, a distant relative of President Chun. The fraud arose because, it seems, Lee and Chang had demanded collateral (in the form of promissory notes) in excess of the sums they had lent and had then re-discounted the promissory notes to other creditors. By repeating this process several times Lee and Chang defrauded the debtor companies of several hundred million dollars. The scandal had a severe impact on the stock market (see Chart 4) where the composite stock price index plunged nearly 10% in less than three weeks. The Bank of Korea immediately attempted to support confidence in the domestic capital markets by providing a stand-by credit facility of US\$150 million to Ilssin Steel Co. and Kong Yung Construction company, and to other creditors.

S. Korea : Chart 4
Liquidity Indicators, Production and the Stockmarket



S. Korea

Chart 5: Real Monetary Growth and Industrial Production



Lee and Chang were, of course, operating in the unofficial short term money, or Curb Market. The significance of this market in the Korean financial system is difficult to assess because of the complete lack of available data. However there are various pieces of evidence to suggest that the Curb Market is an important source of working capital to many heavily-leveraged Korean companies which are unable to provide adequate collateral for official bank loans. Oh Byung-Chan, President of the San Jin Aluminium Co. which was the third publicly quoted company to go bankrupt in the aftermath of the scandal blamed his firm's failure directly on its inability to borrow in the Curb Market which by June had shrunk to a fraction of its normal size. Oh Byung-Chan and others cautioned against the probability of further widespread bankruptcies of medium and smaller sized companies if an alternative source of funds were not made available.

The official reaction, too, seems to undermine the practical importance of the Curb Market. On June 18th the Bank of Korea sanctioned wider participation in the interbank market, encouraging local and foreign merchant banks, finance houses, insurance companies and securities firms to lend directly to the City Banks. This, it is hoped, will improve confidence and liquidity in the Korean banking system. Far more importantly, however, the Bank of Korea dismissed any remaining fears that it would act to restrict monetary growth by revising its monetary target to "at least" 25% growth in M2 during 1982. Virtually simultaneously the Bank of Korea

reduced City Bank Lending rates to 10% from 13.5% and slashed corporation tax from 33% to 20% for listed companies. On August 1st, additional confirmation of the BOK's easier monetary stance was confirmed when a Ministry of Finance official suggested that growth in M3 could reach 35% this year, while M2 could average 30-32%.

FORECAST: The first trough of the recent Korean recession occurred in mid-1980. Like the Japanese economy, South Korea began to recover in 1981, but stalled as its exports flagged in weak overseas markets. The Bank of Korea responded by easing up significantly at the end of 1981 and in early 1982, dropping its discount rate sharply and allowing monetary growth to accelerate. A secondary trough in activity in early summer coincided with the Curb Market Scandal which has induced the Bank of Korea to loosen up further. When the recovery comes in a few months' time, Korea's upswing should be a strong one, due to the large injections of liquidity from the Bank of Korea consequent upon its change of direction around yearend 1981 (see Chart 5) and due to the additional stimulus which it has provided since the Curb Market Scandal in May. Unfortunately the expansion will also bring with it a higher rate of inflation because money growth rates in the region of 30% p.a. are simply too high even for an economy with South Korea's dynamism and growth potential, and this will also mean that the currency will be somewhat weaker than it might have been. Sadly the monetary discipline which had been fairly consistently enforced since 1978-79 has been ditched, at least temporarily, and that implies a return to the wild roller-coaster of the 1960's and 1970's. Hopefully, South Korea's aberration will only be short-lived, but meanwhile investors and businessmen should take appropriate precautions.

THAILAND

WHY LIQUIDITY IS EASING SHARPLY

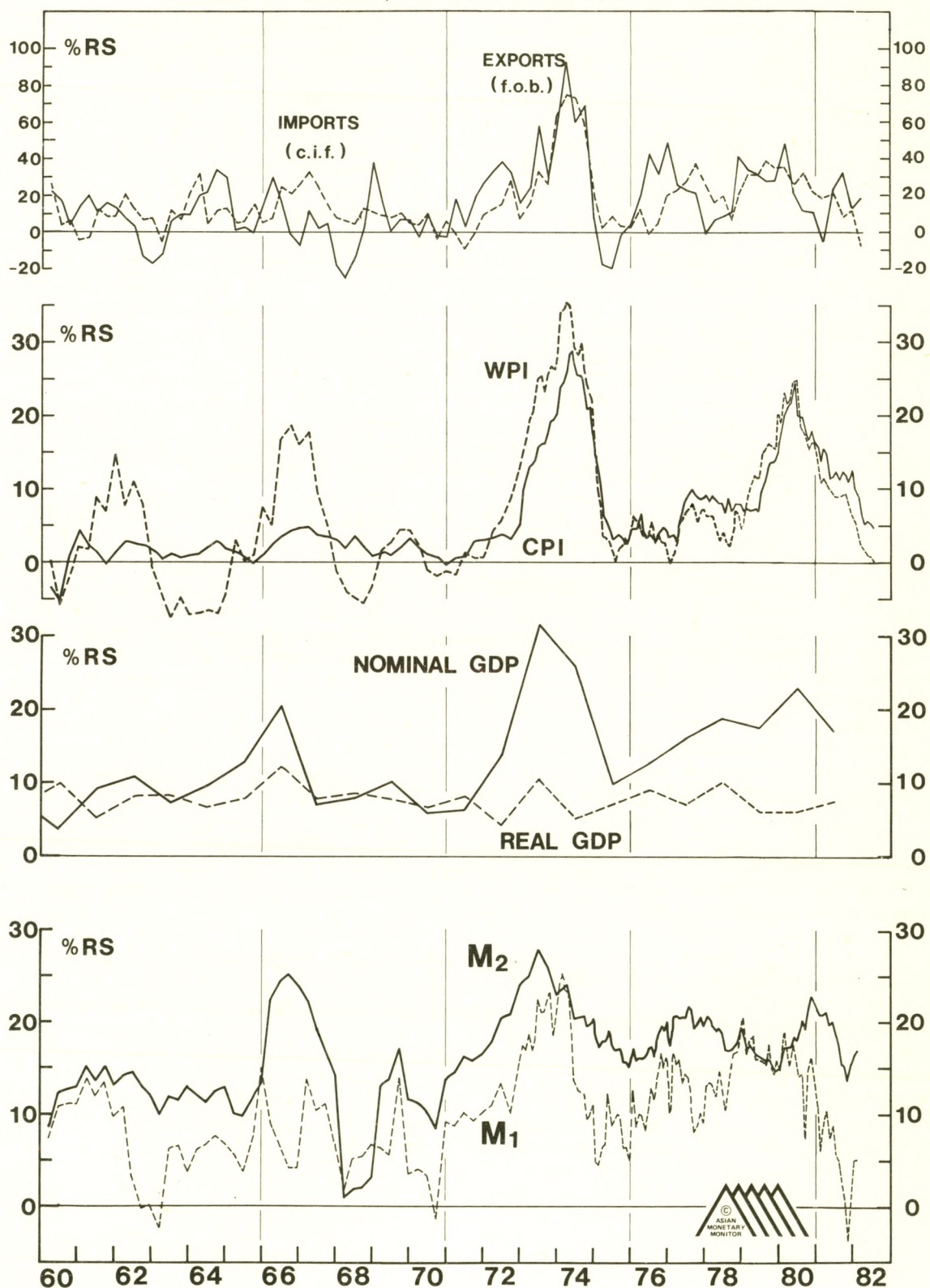
Over the past year and a half the Thai economy has undergone a prolonged monetary squeeze. M2 growth had fallen from its peak of 22.7% at the end of 1980 to 17% by April of this year, while M1 growth fell from 13.8% for the whole of 1980 to only 1.7% for the whole of 1981. The benefits of this squeeze have now become evident. Inflation as measured by the consumer price index has fallen from its peaks of over 20% in 1980 to around 5% now. The trade account has moved from a deficit of Baht 36 billion for the first seven months of 1981 to a deficit of just over Baht 15 billion for the first seven months of 1982, with exports growing at around 15% and imports registering a 5% decline. Admittedly, the fall in inflation can be partially attributed to the sharp fall in rice prices over this period, and the marked improvement in the trade account to a bumper rice crop and the success of the July 1981 devaluation of the baht. However, there can be little doubt that imports and inflation have been held down by the persistence of the domestic monetary squeeze.

The result of the tightness of liquidity over the last eighteen months is that conditions are now in place for a strong economic recovery and a recovery in the stockmarket, which is already underway. Any recovery in agricultural commodity prices from their very depressed levels would be met with a further improvement in the trade account and a sharp pick-up in demand and economic growth. However, there is already clear evidence that liquidity is improving and an improvement in economic activity can be expected to follow. The purpose of this article is to examine the factors behind the rapid slowdown in monetary growth since the end of 1980 and demonstrate why these factors will now operate in reverse to ease liquidity and spur economic growth.

A good way of looking at trends in liquidity is to examine the behaviour of the monetary base. The year-on-year rate of growth of the monetary base dropped from a peak of close to 20% in the middle of 1980 to roughly 6% by the middle of 1981 and since then has fluctuated in a range of between 5% and 7% over the period in which statistics have been available. In a previous edition of AMM (Vol. 5 No. 5) we analysed the components of monetary base growth and demonstrated that monetary base growth was maintained at a high level over the period 1978-1980 by the acceleration in the growth of the domestic component of the monetary base i.e. despite a continuing deterioration in the overall balance of payments any drain on the reserves of commercial banks was more than made up for by Bank of Thailand purchases of bills or direct loans to commercial banks. Thus over this period the fixed exchange rate mechanism by which a balance of payments deficit should lead to a slowdown in monetary growth and hence a decline in import growth and correction of the deficit was not allowed to work.

THAILAND

CHART 1 : MONEY, OUTPUT, PRICES, AND TRADE



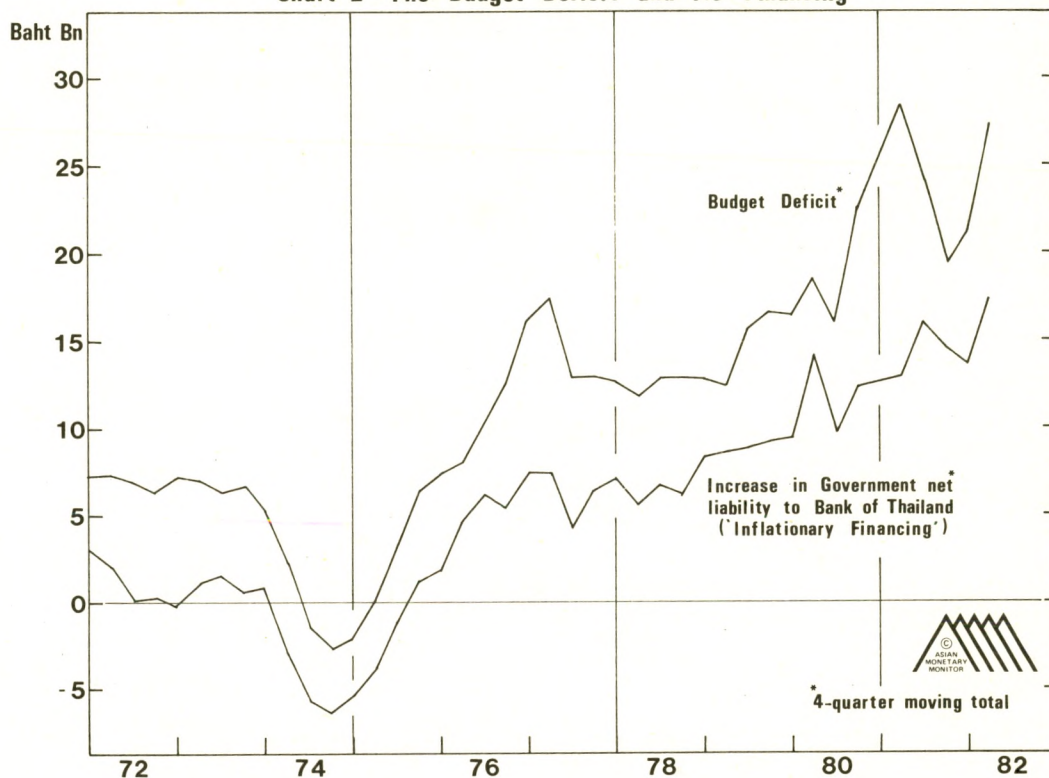
In practice, as Thailand is a developing economy without a secondary bond market or developed financial system, it is the financing of the budget deficit which provides the important part of domestic monetary expansion i.e. the Bank of Thailand buys bills from the Government and its balance sheet expands. As the money is spent on development projects or general government expenditure so funds are transferred from the Treasury's account with the Bank of Thailand to the commercial banks' accounts and the monetary base is expanded. Chart 2 tracks the course of the budget deficit over the period 1972 to 1982 and splits the financing of the deficit into that part which is 'directly inflationary' and that part which is only indirectly inflationary or non-inflationary. By 'directly inflationary' we mean that the financing increases the monetary base directly by increasing government net liabilities to the Bank of Thailand i.e. a decrease in government deposits with the Bank of Thailand or Bank of Thailand purchases of government bonds. The remainder of budget deficit financing consists largely of borrowings from commercial banks or from overseas. In that overseas borrowings result in a capital inflow then this will also tend to lead to an increase in the monetary base, but as this will be part of the 'foreign' or 'balance of payments' component of monetary base growth we are not considering it in this part of the analysis, and have hence included it in the 'non-inflationary' part of deficit financing.

The figures plotted in Chart 2 represent four quarter moving totals of the underlying data and clearly show the growth in the budget deficit since 1975 and the accompanying growth of directly inflationary deficit financing. It is this which offset the sharp decline in the overall balance of payments from 1975-1979 illustrated on Chart 4, and enabled monetary growth to be maintained at a high level over this period. Chart 3 compares the same series for the inflationary component of deficit financing with the domestic component of monetary base expansion (i.e. a series derived from the Bank of Thailand's balance sheet as the residual left after subtracting increases in net foreign assets from increases in the monetary base) also measured as a four quarter moving total. The close correspondence between these two series clearly illustrates that it is the growth of the budget deficit which has been the source of domestic monetary expansion.

In 1980 monetary growth exploded as the trend in the overall balance of payments turned sharply to surplus and the budget deficit grew rapidly. However, the situation reversed itself at the beginning of 1981. National government expenditure grew only 9.8% for the whole of 1981 compared to 32.0% in 1980 and consequently the budget deficit began to shrink slightly. Moreover and more importantly, the overall balance of payments turned back into large deficit. These two factors together resulted in the sudden slowdown in monetary base growth which led to the monetary squeeze.

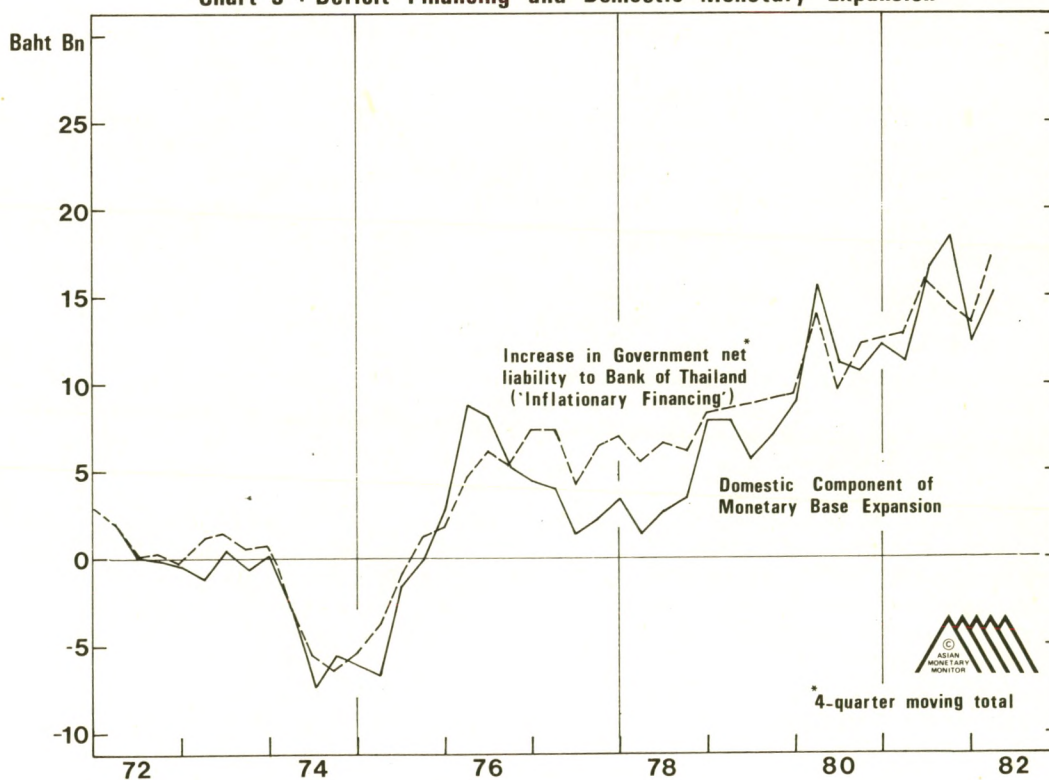
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Chart 2 : The Budget Deficit and its Financing



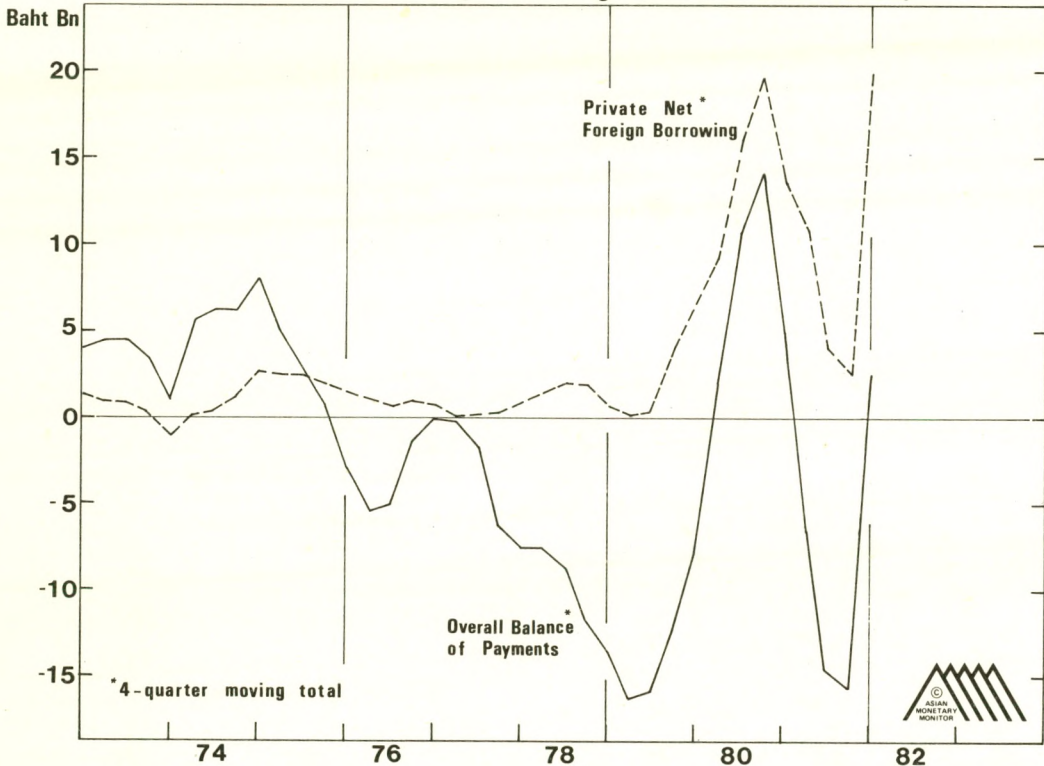
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Chart 3 : Deficit Financing and Domestic Monetary Expansion



THAILAND

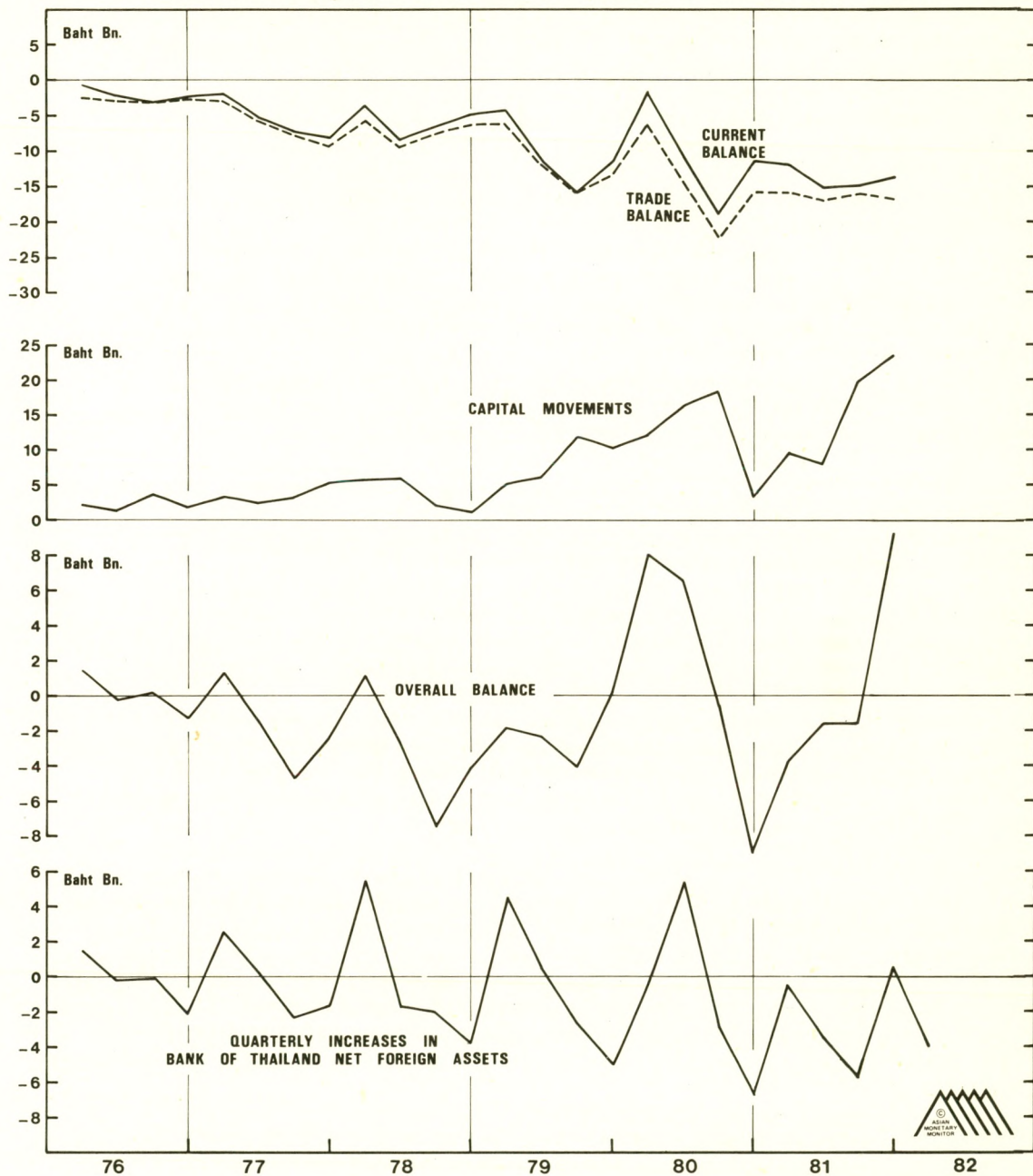
Chart 4: Private net Foreign Borrowing and the Balance of Payments



The trend in the balance of payments is illustrated on Chart 4 which depicts a moving total of the overall balance of payments as well as one of the components of the overall balance - loans and credits to private enterprises, which is one of the items in the capital account. It can be seen clearly that the sharp swing of the overall balance into surplus in 1980 and the swing back into deficit in 1981, which was largely responsible for the trend in liquidity over these years, was due mainly to the loans and advances component of the capital account. The high level of capital inflows arising from private foreign borrowings fell away sharply in the middle of 1980 and it was this which primarily created the tight money conditions which have persisted until recently. However, tight money conditions were not inevitable in so far as the Bank of Thailand could have taken offsetting action by monetising a higher proportion of the government's deficit. Rather, it seems likely that the slowdown in monetary growth was compatible with the Central Bank's policy over the period, but the primary cause of the slowdown was the fall in overseas borrowings.

The drop in overseas borrowings is obviously attributable to the persistence of high interest rates overseas stemming from the end of 1979 when the U.S. Federal Reserve changed its monetary policy to one of concentrating on monetary targets and allowing interest rate flexibility. Interest rates in Thailand are fairly rigidly controlled and when they are altered it is always some long time after monetary conditions become appropriate for change. So interest rates in Thailand were

THAILAND : CHART 5
The Balance of Payments and the Bank of Thailand's Net Foreign Asset Position



slow to respond to the upwards moves in overseas interest rates and consequently Thai borrowers switched to the lower domestic rates for their borrowings and paid back their overseas debt. This can best be seen by studying the overseas borrowing behaviour of the commercial banks.

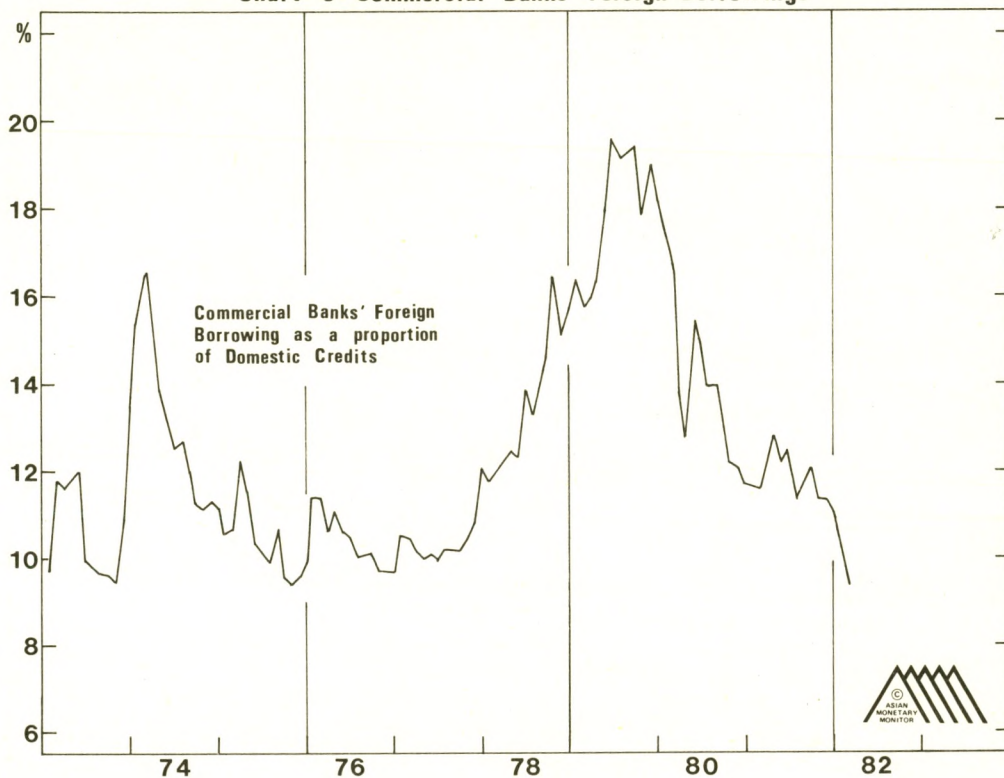
Commercial banks in Thailand have always relied fairly heavily on overseas borrowings, mainly U.S. dollars, to fund their domestic credits. Chart 6 illustrates monthly values for the percentage proportion of domestic credits funded from overseas borrowings over the period 1973-1982. It can be seen that the peak level of overseas borrowings was reached in the autumn of 1979 when commercial banks' borrowing from overseas was equivalent to between 19% and 20% of their total bills, loans and overdrafts. By February of this year this ratio had dropped back to 9.3%. The drop in this ratio translates into a capital outflow of roughly Baht 10 billion compared to an inflow of over Baht 15 billion which would have resulted had the ratio remained at its end 1979 levels.

Within the overall downtrend, commercial banks' borrowings can be seen to have been responsive to short term movements in overseas interest rates. This can be seen from Chart 7 which compares the overseas funding ratio (inverted) with the Federal Funds rate on a monthly basis from July 1979 to February 1982. Of course other factors affect commercial banks overseas borrowing behaviour. There was widespread speculation against the baht before the July 1981 devaluation, and after the devaluation the U.S. dollar value of banks' overseas debt was obviously greater, so in some sense the ratio understates overseas debt from then onwards. But the overall pattern makes clear the importance of overseas interest rates for domestic borrowing behaviour, and thereby for the balance of payments and liquidity conditions.

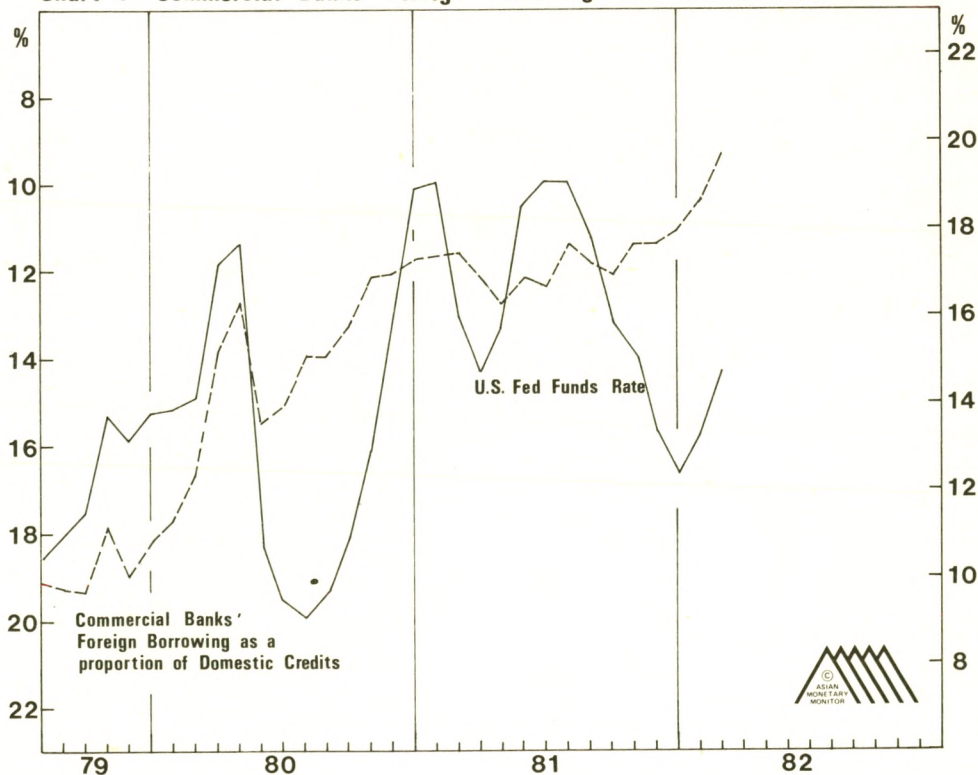
Charts 6 and 7 thus provide an illustration of two trends - the longer term decline in private overseas borrowing that has occurred since overseas interest rates became high and erratic and, within that trend, shorter term fluctuations in response to movements in overseas rates. This confirms the importance of the link between domestic and overseas, particularly U.S., interest rates as a determining factor of trends in the Thai economy.

FORECAST: The primary cause of the rapid slowdown in monetary growth over the 1981/1982 period was capital outflows arising from the high level of overseas interest rates and the consequent deterioration in the balance of payments. The Bank of Thailand chose not to offset the effect of this drain on the monetary base but instead allowed monetary base growth, and hence money growth, to slow down sharply. This fall in monetary growth has had favourable effects for inflation and for the trade account.

THAILAND
Chart 6: Commercial Banks' Foreign Borrowings

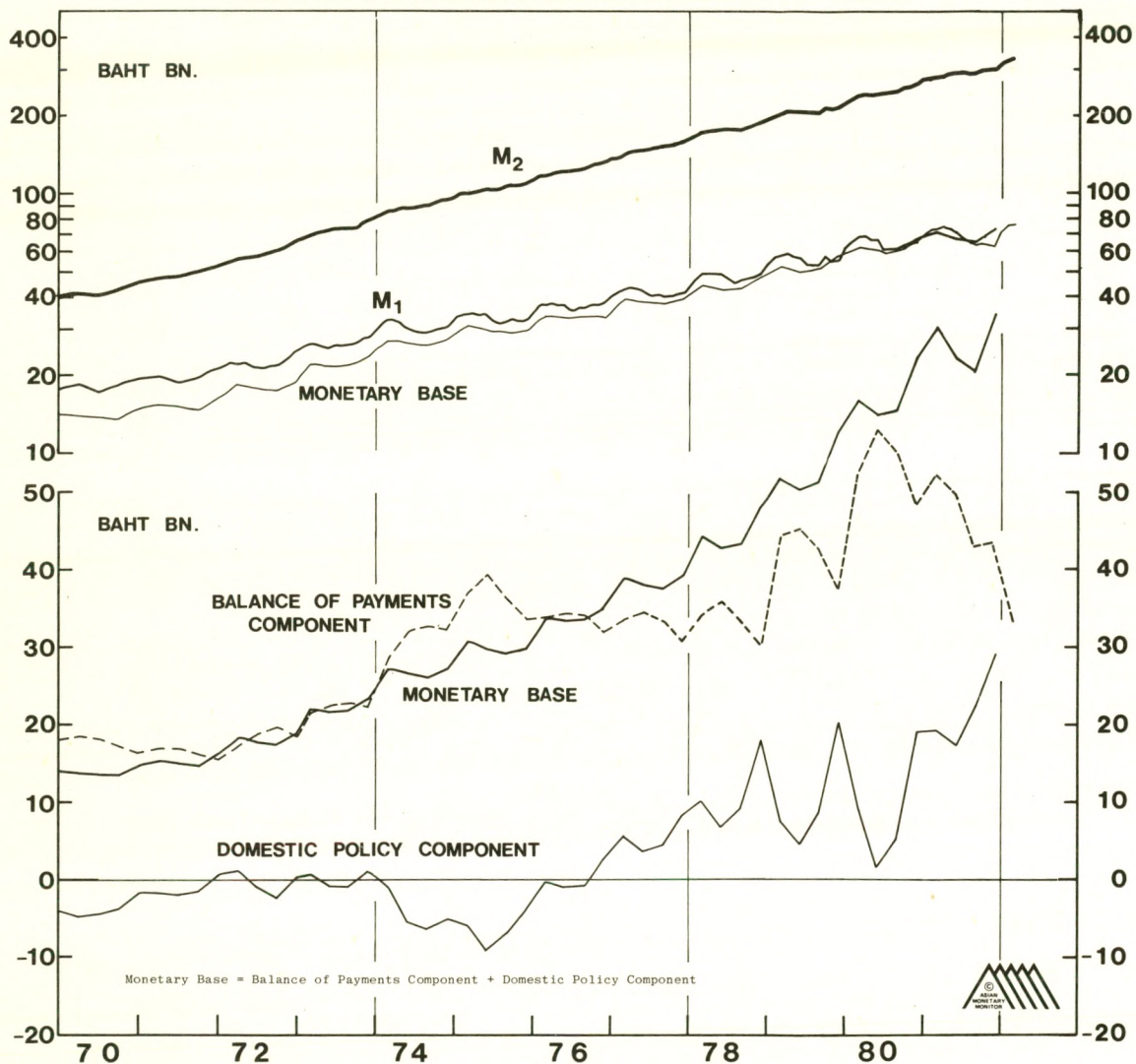


THAILAND
Chart 7: Commercial Banks' Foreign Borrowings and the Federal Funds Rate



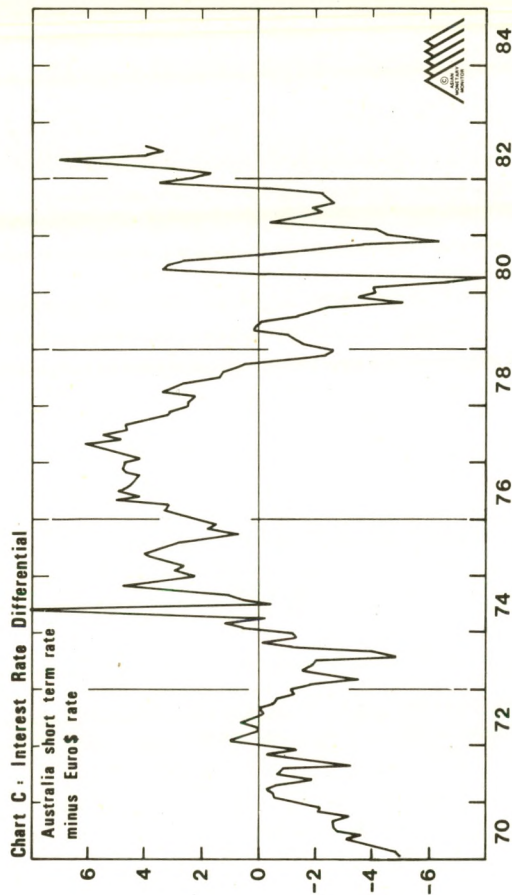
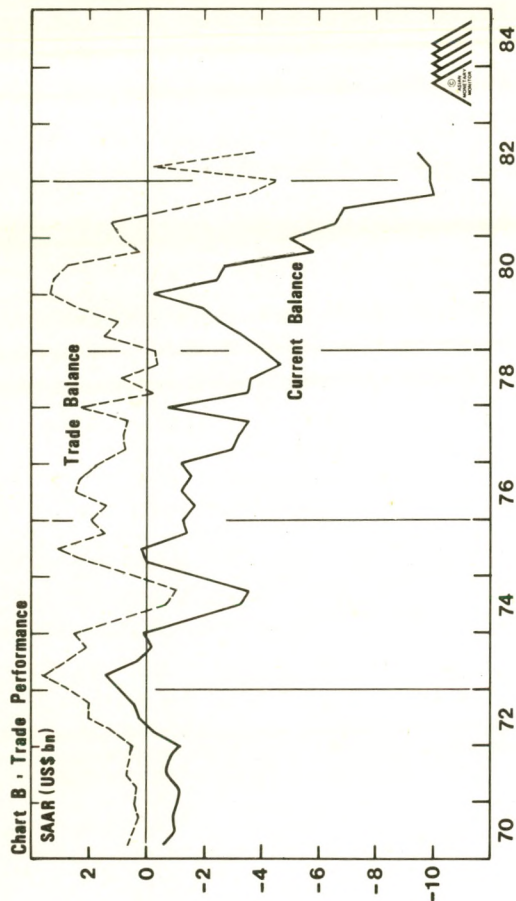
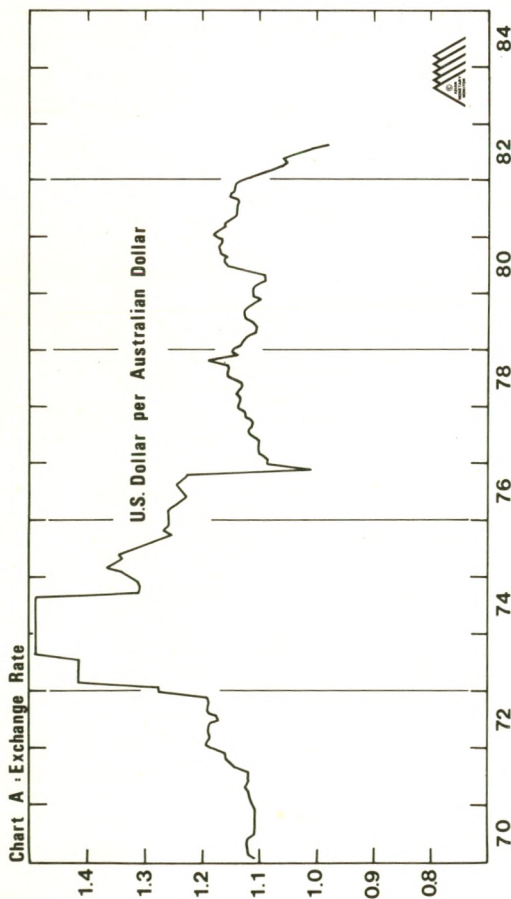
THAILAND

CHART 8 : MONEY AND MONETARY BASE



We are now at the beginning of a sharp reversal in the factors which led to the monetary slowdown, and consequently should see a period of much easier liquidity over the next year or so. Interest rates in the U.S. have recently fallen sharply and should fall further early next year. This will mean a restoration of capital inflows as overseas borrowings by commercial banks and other enterprises return to a more normal level. This will be on top of the marked improvement in the trade account and hence will leave the overall balance of payments firmly in surplus. With inflation at a low level this will mean easier liquidity which would be further improved by any pick up in commodity prices. Hence we should be in for a period of buoyant economic activity in Thailand with, barring unforeseen political troubles, further sharp improvements in the stock market to be expected.

AUSTRALIAN DOLLAR



The Australian dollar has fallen below parity to the US\$ for the first time, on the back of record trade and current account deficits, a continued high level of monetary growth and an inflation rate which has not fallen in line with those of other major economies. The figures for the 1981/82 fiscal year, ended in June, reveal a record current account deficit of A\$9.10 bn., or roughly 6% of Gross National Product. The trade deficit for the year soared to A\$3.4 bn., with imports surging by 17% but exports managing a growth of only 1%.

The rapid deterioration in Australia's external position has occurred as the Australian business cycle has moved out of line with the world economic cycle. This has happened as a growing inflow of private capital has enabled the maintenance of a high level of monetary growth to occur simultaneously with a rapid deterioration in the current balance. A capital inflow totalling A\$10.5 bn. in fiscal 1981/82 resulted in the overall balance of payments recording a surplus over the year. Surpluses in the overall balance have provided the basis for the continued high level of monetary growth and domestic economic activity. The result has been a rapid growth in imports, while exports have suffered in the face of world recession and falling commodity prices.

Inflation has remained at a high level. In the quarter ended June 30 Australian consumer prices rose at an annual rate of 10.7%, up from 10.5% in the preceding quarter. Consequently, the Australian dollar has remained significantly overvalued on a purchasing power parity basis (Chart D) despite its recent depreciation.

The basic strength of the Australian economy over the past two years has rested primarily upon a high level of capital inflow, which, in the absence of any offsetting action by the Reserve Bank of Australia, has led to rapid monetary growth despite a deteriorating trade position. This situation has proved unsustainable and we can now expect a period of deterioration in the overall balance and a slowdown in monetary growth. Monetary growth in the second quarter was strong with the year-on-year growth in M3 for June registering 11.3% and M2 recording 13.9%, but the trend is now downwards. Until the monetary slowdown has acted to correct external imbalance we can expect a prolonged period of weakness in the Australian dollar and even in the event of further cuts in U.S. interest rates we do not expect to see any marked appreciation against the U.S. dollar.

ACTUAL FORECAST

US\$/A\$	1982 Q2	Jul.-Aug.	Q4	1983 Q1
FORECAST A				
Actual Range	1.0685-1.0179	1.021-0.9647	0.96-0.90	0.92-0.88
FORECAST B			0.96-0.90	0.94-0.90

Forecast A assumes that US interest rates remain at current levels throughout the forecast period.

Forecast B assumes that US interest rates begin a further decline in early 1983.

Chart D : Price Competitiveness (adjusted for exchange rate changes)

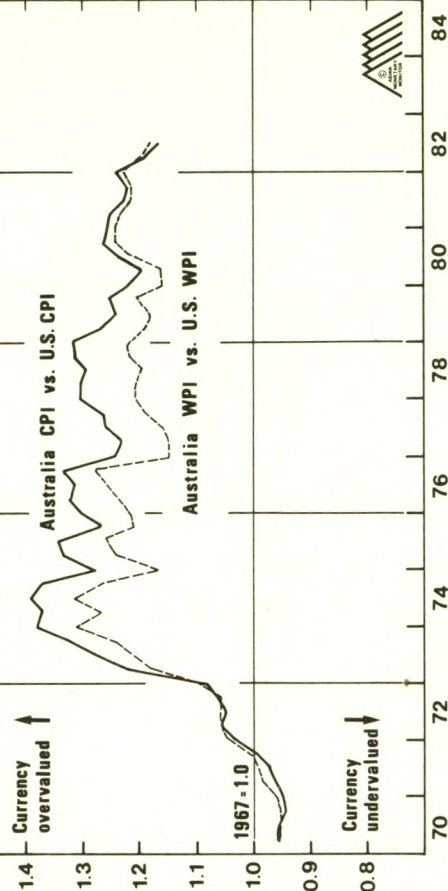
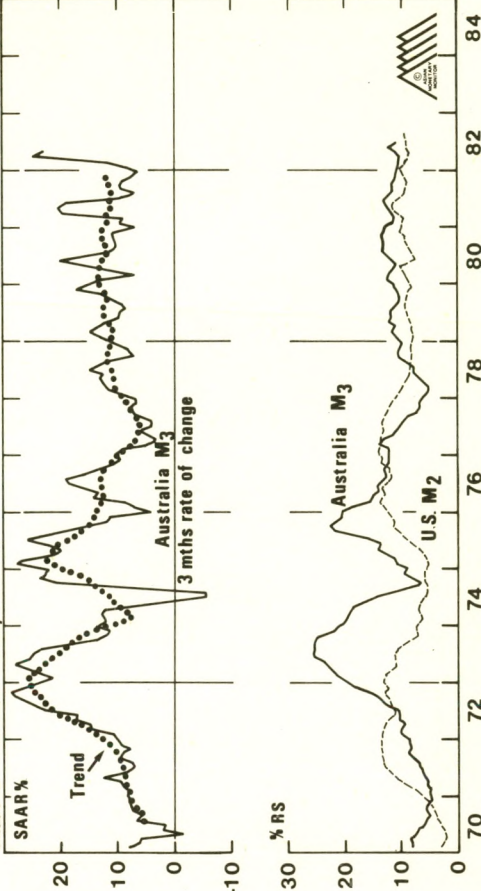


Chart E : Relative Money Growth



INDONESIAN RUPIAH

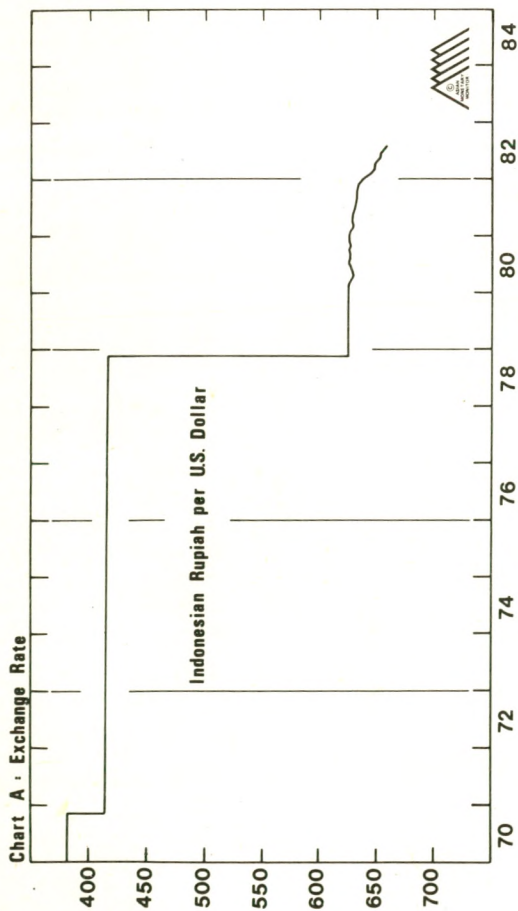


Chart B : Trade Performance

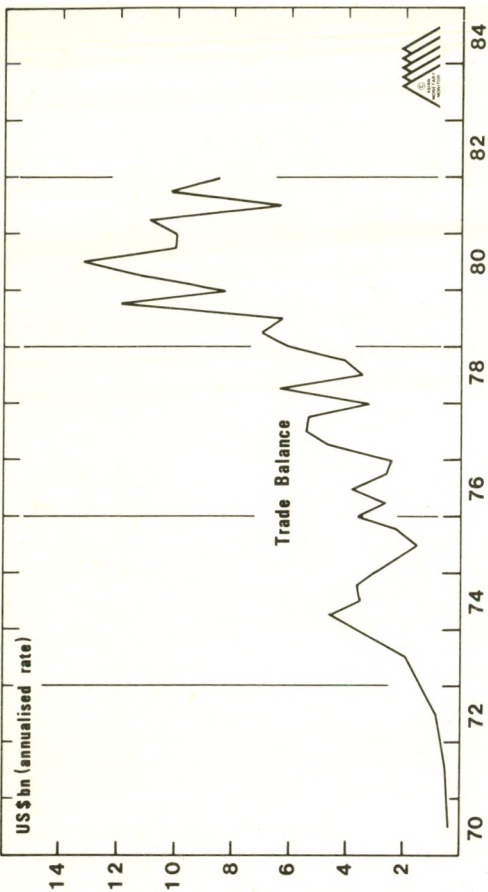
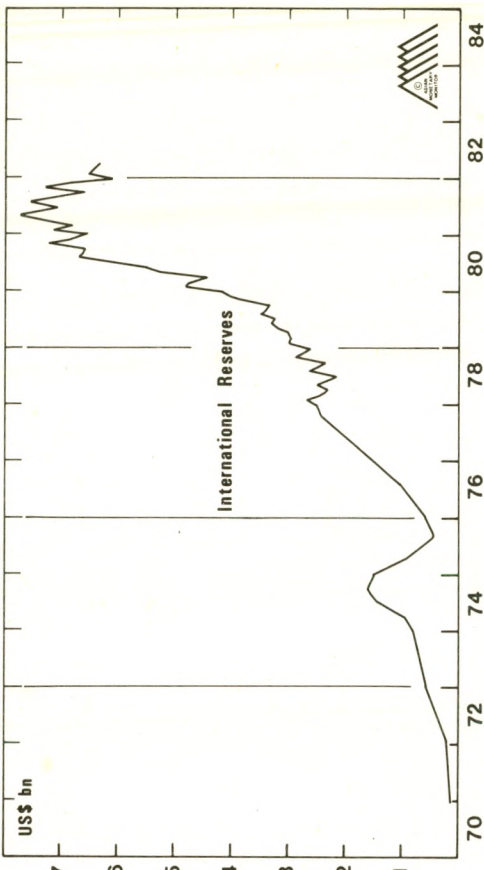


Chart C : International Reserves



The Indonesian Rupiah has continued to depreciate slowly against the US dollar, but, despite persistent rumours and speculation against the Rupiah on the foreign exchanges, the Bank Indonesia has so far managed to avoid an outright devaluation of the Indonesian currency. The President and government officials have repeatedly denied the possibility of a devaluation. Official reluctance to pursue this option probably stems from the relative lack of success of the 1978 devaluation, which was followed by a period of very high inflation and overheating of the domestic economy. However, circumstances were slightly different at the time of the 1978 devaluation, coming as it did before the second oil price hike and a commodity boom which took Indonesia's balance of payments into a strong surplus, in turn resulting in excessive monetary growth and inflation. This led to the high rate of import growth which has contributed to Indonesia's current problems.

A pick up in import growth and stagnation in exports resulted in the current account of the balance of payments moving from surplus in 1980 to a \$1.2 bn. deficit in 1981. The balance of payments has deteriorated further this year as export revenues have declined in the wake of falling commodity prices and cutbacks in oil production. Non oil and gas exports dropped 42% in the first half of 1982 and,

as a member of OPEC, Indonesia has had to cut back oil production from 1.6 million to 1.3 million barrels per day.

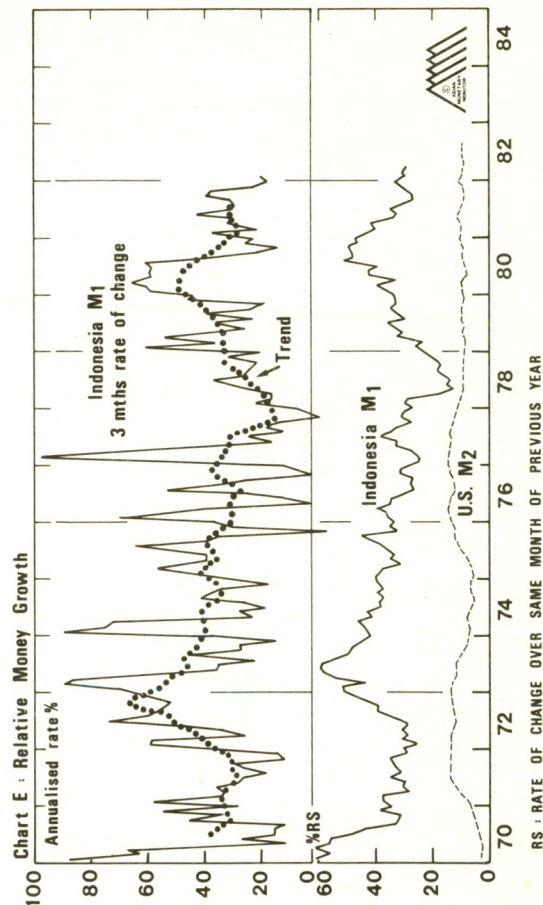
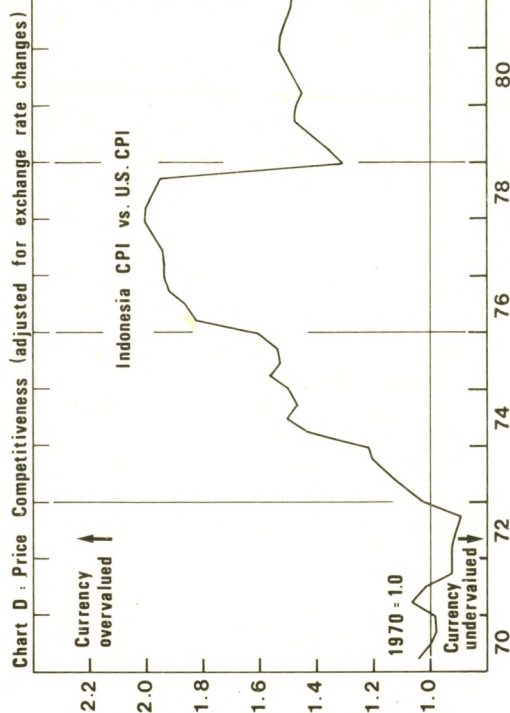
The sharp deterioration in the external position has had one favourable consequence in that it has helped slow down monetary growth and hence inflation. Inflation is now down to an annual rate of around 9%, and the authorities are determined to maintain the rate within single figures. However, the Rupiah still remains substantially overvalued on a purchasing power parity basis (Chart D).

Thus, fundamental factors and Indonesia's falling international reserves would point to a devaluation of the Rupiah. However, it seems likely that the authorities will be able to continue to stave off that eventuality mainly as a result of Indonesia's overseas borrowings which are continuing to lend support to the overall balance of payments. Indonesia will soon have raised close to \$1 bn. in syndicated and commercial credits in just a year. In this respect it is significant that President Suharto has pledged not to cut back this year's development budget which, with spending of \$13.76 billion represents a 34.5% increase over last year's figure. Consequently, it seems likely that at least over the medium term we will continue to see a continuation of the gradual slide of the Indonesian Rupiah against the US dollar. However, unless there is a pick up in commodity prices and oil demand, in the longer term an outright devaluation may prove inevitable.

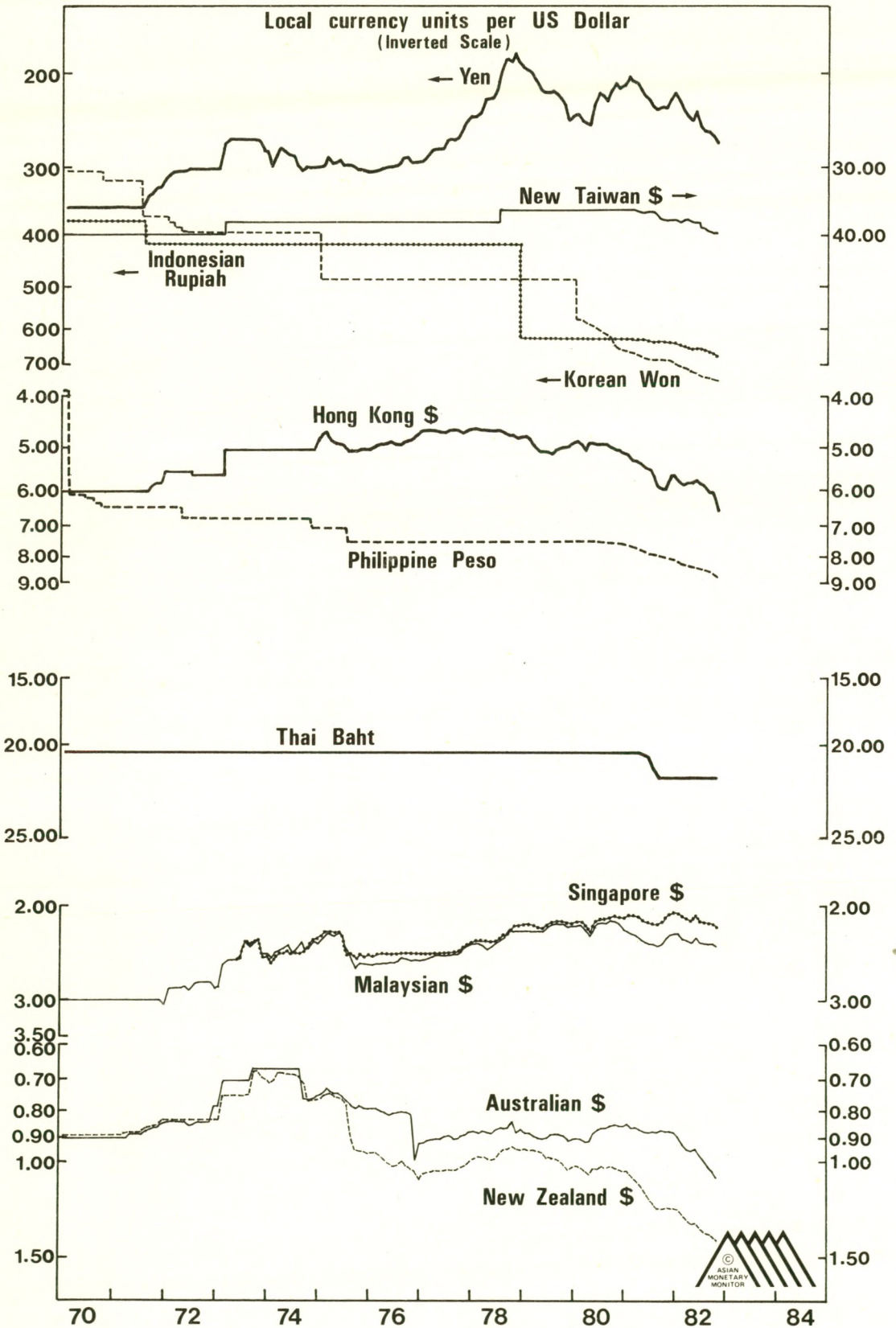
Rupiah/US\$ FORECAST A Actual Range FORECAST B	ACTUAL		FORECAST	
	1982	Q2	Jul.-Aug.	Q4
	648.00-654.25	654.25-661.75	662-690	690-710
			940-950	950-960

Forecast A is the most likely range in the absence of a major political or external disruption.

Forecast B is based on a tentative projection of relative price competitiveness depicted in Chart D i.e. the exchange rate required to bring US and local price levels approximately into line.



EXCHANGE RATES IN THE FAR EAST

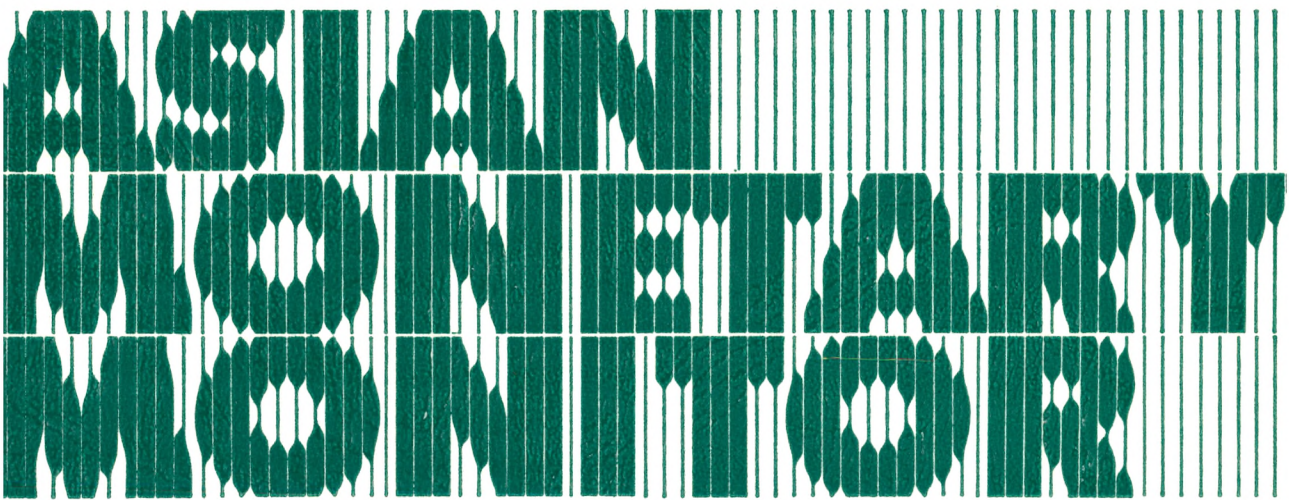




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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of
preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

REGIONAL SURVEY

'FUNDAMENTALS' VERSUS 'INTEREST RATES' IN FOREIGN EXCHANGE MARKETS

The causes of movements in foreign exchange rates can broadly be classified into two sets of factors: rational and irrational. The rational factors are all those economic events or trends which separately or in combination can help to explain changes in the demand for or supply of any currency. The irrational factors, which are none the less real, include all those non-economic events which from time to time disrupt the underlying pattern of economic cause and effect. A famous example of a non-economic event which had a sudden and pronounced effect on foreign exchange markets was the assassination of President Kennedy in November 1963. As soon as it became clear that Vice-President Lyndon Johnson had taken over, that the transition was orderly, and that LBJ was going to continue with the programmes of his predecessor at home and abroad, foreign exchange markets reverted to normal, and central banks were able to unwind their dollar support operations.

In general such irrational movements of exchange rates will tend to be transient and self-reversing. On the other hand, rational movements will tend to be more durable, and will have no such necessary tendency to reverse themselves. Equally one may say that the shorter the time horizon, the more difficult it is to provide 'economic' (i.e. rational) explanations for exchange rate movements, whereas the longer the time horizon the more likely it is that 'economic' explanations can be found for exchange rate changes.

This classification is obviously not watertight. Some events may cause people to react irrationally, but subsequent changes in policy may provide an economic rationale for these initial reactions. For example, when Britain first lost the Falkland Islands to Argentinian occupation, sterling weakened sharply - essentially an irrational reaction. When it later became clear that Mrs. Thatcher would not resign, and hence that her domestic fiscal and monetary policies would remain in place, and that in addition, the real incremental cost of the South Atlantic expedition could be contained within the annual defence budget, sterling recovered. Rationality prevailed. However, if Mrs. Thatcher had indeed resigned and her policies had been ditched by her successor, then sterling's initial weakness might have been fully justified by later events. A Labour government would almost certainly have overthrown her monetarism and her controls on government spending, subsidies and transfers. Thus, to react irrationally is not necessarily to be wrong and, conversely, a rational response is not necessarily right either.

In this complex environment, several possible approaches to foreign exchange risk management are possible. These may be classified under three headings: econometric, technical, and

judgmental. The "econometric" approach is any system which uses a framework based on well-established past relationships between an exchange rate and any other economic variables, and projects that relationship into the future. (N.B. It need not rely on a formal econometric model.) "Technical" systems rely solely on the pattern of past movements of the exchange rate itself, plus a miscellany of market wisdom based on experience about how that rate may move in the future. The "judgmental" approach is essentially eclectic, selecting whatever information appears to be important to the observer at the time, and may extend to the inclusion of all kinds of intangible, unmeasurable events such as political shocks, or sunspots, or the occurrence of a great earthquake.

The best justification for an eclectic approach - apart from the test of success - is the apparent tendency for different types of factors to dominate exchange rate movements at different times. This type of shift in emphasis - so evident in the markets - cannot be easily captured within the framework of an econometric model, and technical services in any case ignore the background changes, preferring to concentrate on the pattern of price movements themselves. It is, therefore, essential to know and understand which types of forecasting will be successful under different conditions.

Perhaps the most widely known example of a change in the cause of currency movements is the shift from so-called "fundamentals" (i.e. trade balances and inflation rates) to interest rate differentials in the past three or four years. The yen-US dollar relationship provides an excellent illustration of this shift. In 1977-78 the interest rate differential between yen and US dollars was persistently widening as US interest rates rose and Japanese rates fell, and yet instead of weakening, the yen strengthened throughout the period. (See Chart 1.) Clearly "fundamental" factors - the strength of Japan's trade and current balance and the lower inflation rate in Japan - were the dominant force in the markets. (Chart 2).

However, since that period up until mid-1982, interest rates clearly became the senior partner in exchange rate changes. Each time US interest rates rose, or were widely anticipated to rise, the leading currencies such as the DM, sterling and the yen which were not pegged against the US dollar, almost invariably slipped in value. (Chart 3). However, since US interest rates began to fall steeply in August, the dollar has remained universally strong, suggesting that once again we may be moving from a period in which interest rates are the dominant force in the markets to another period when "fundamentals" predominate once more. Clearly these shifts are nothing new, and by the same token they are not unusual. The problem is to identify the cause of a shift from, say, "fundamentals" to interest rates. In 1974-75 a similar shift occurred, but it was masked at least to some extent by the controls on interest rates in Japan at that time, and to some degree by the existence of controls on capital flows. The reason for such shifts, we believe, is closely connected with the shape of the yield curve in both countries.

"FUNDAMENTALS" versus

CHART 1

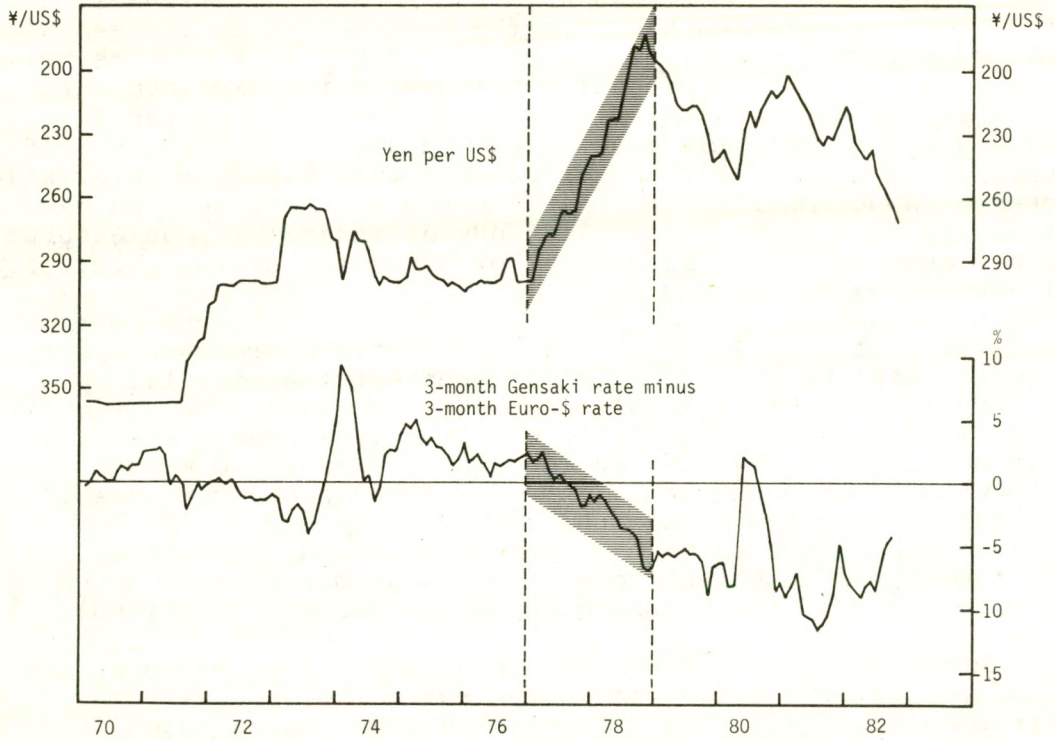
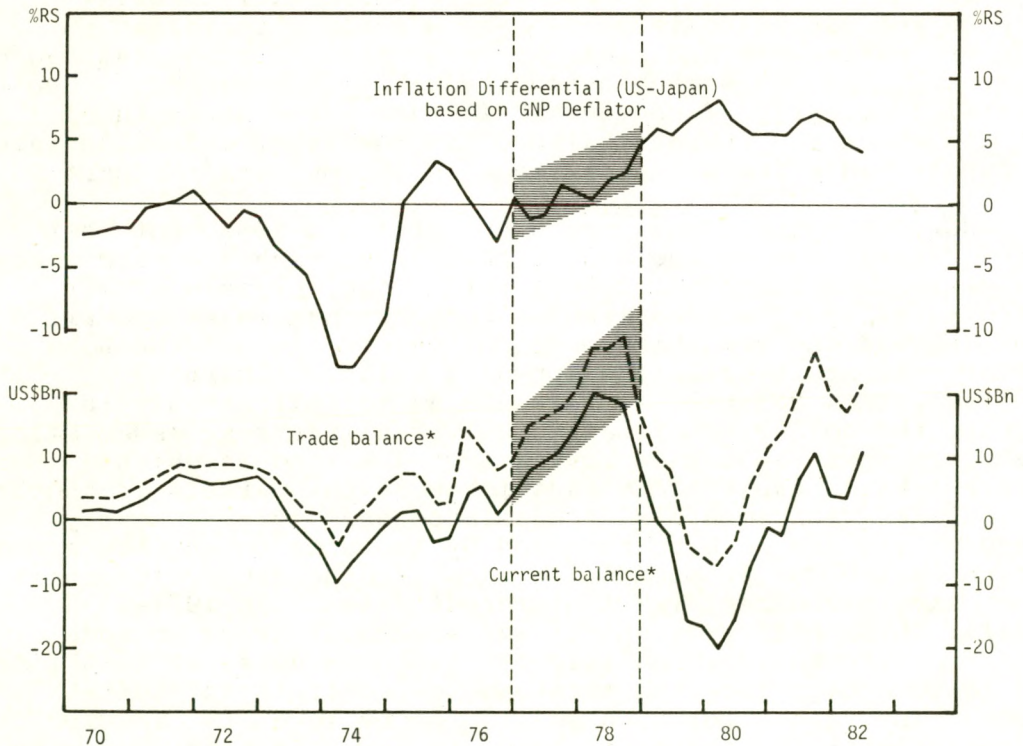


CHART 2



* Seasonally adjusted at annualised rate

"INTEREST RATES"

CHART 3

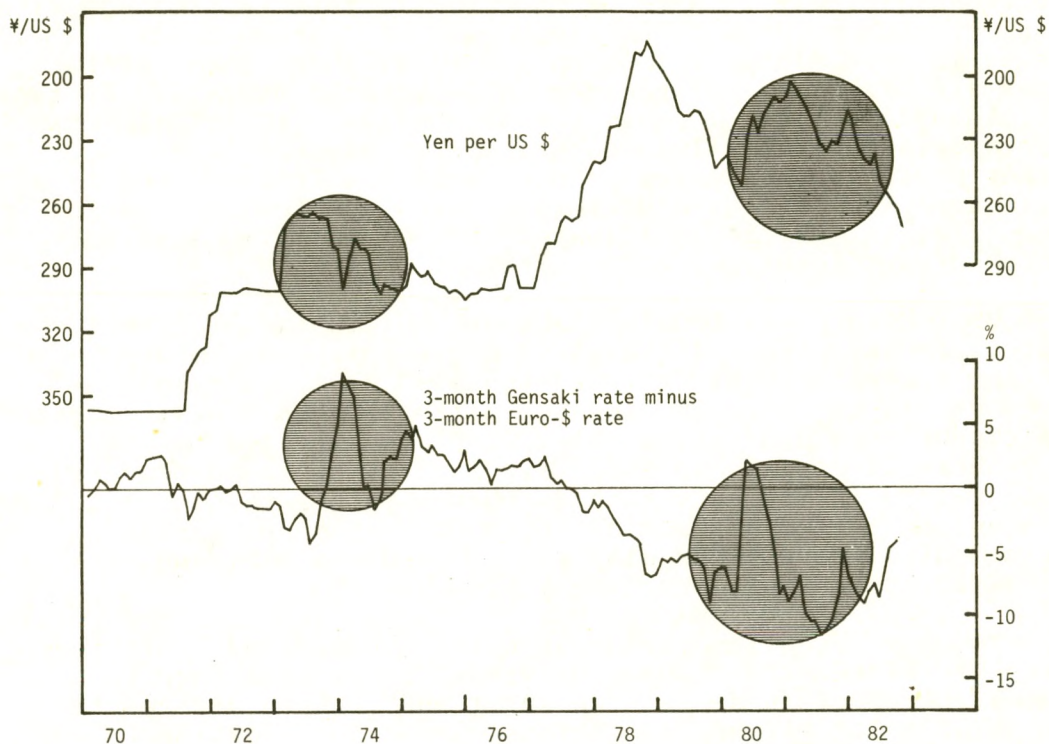
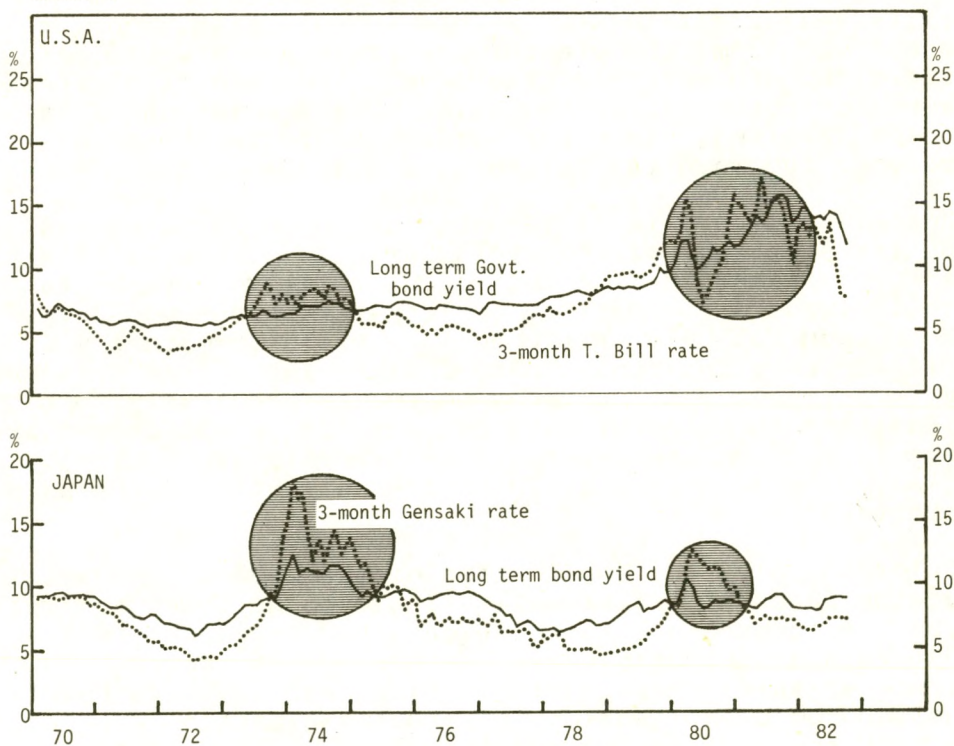


CHART 4



As a general principle, it would seem that when the yield curves in two countries are normal or positive (i.e. short-term interest rates are lower than long-term rates), interest rate differentials will tend to be marginal factors in exchange rate changes. However, when the yield curve in either country has an inverse slope or is negative (i.e. short-term interest rates are higher than long-term rates), interest rate differentials will tend to dominate exchange rate changes. (Chart 4). It should be said that all these statements apply as much to market participants' expectations about the future trend in any variables (e.g. expected interest rates, or the next set of trade figures, or the anticipated rate of inflation) as to their current levels.

What kind of rationale might one put forward for the idea that it is the shape of the yield curve which determines whether interest rates or "fundamentals" will dominate movements in the foreign exchange market? When long-term rates are higher than short-term rates (and are expected to stay that way) there is clearly an incentive for investors to place funds in long-term instruments such as bonds, rather than to hold them on short-term deposit or in short-term money market instruments. Given generally stable conditions, funds will gradually spread out along the yield curve.

However, when the yield curve is inverted and short-term rates are higher than long-term rates, there will tend to be concentration of funds "at the short end". When offered the choice of holding funds in various currencies yielding different returns investors will tend to be much more sensitive to the differences in short-term yields than to differences in long-term yields. This is because the shorter the term, the less risks and uncertainties one has to cope with. Conversely, the longer the term, the greater the risks and uncertainties to be dealt with. For example, the longer the term, the greater the scope for potential appreciation or depreciation of the currencies involved. In other words, the further one gets from the present, the more the future is clouded.

Hence when the bulk of funds in any country is skewed towards the short end of the yield curve, people will tend to have a much clearer idea of their real relative returns than when their funds are committed to long-term paper whose real return depends not only on the nominal yield to maturity in domestic currency, but on a host of other factors as well. It is for this reason that currency movements are likely to be more sensitive to interest rate changes when yield curves are negative (i.e. when short-term rates are relatively high), and during such times one would expect less attention to be paid to "fundamentals".

Unfortunately, the application of the term "fundamentals" to trade balances or inflation is liable to be taken to imply that changes in exchange rates which occur as a result of interest rate differentials are somehow not warranted. In our experience sustained changes in exchange rates always have a rational economic explanation, but that explanation does not always rely on the same intermediate factors in the same proportions. There is clearly a premium on identifying whether interest rates or the balance of trade or relative inflation

rates will be dominant.

With careful analysis of the business cycle in different countries we have found that it has generally been feasible to be right about the general direction of any of these individual factors, if not always about the precise timing, at least for any one country. The real skill and the big rewards come when one can successfully predict the trends in these factors in two countries, and when one can correctly forecast the implications of that interaction.

CONCLUSION: In a world of floating exchange rates and independent monetary policies, business cycles in different countries are likely to continue to diverge. It is this divergence in levels of activity and rates of inflation which, when properly analysed and understood, provides opportunities (and risks) in foreign exchange management. At certain times, so-called "fundamentals" (i.e. the balance of trade, the current balance, or the inflation rate) have been deemed to be the dominant factors in foreign exchange rate determination. At other times interest rates have been deemed to be all-important. At a superficial level the explanation is that in recent years interest rates have only appeared to be especially significant when the yield curve in any of the countries concerned has been negatively sloped.

At a deeper level, the truth is that interest rates, trade balances, current balances, and inflation are all merely symptoms or effects of the underlying pattern of monetary growth. The reason that the shape of the yield curve is significant is that its slope (positive or negative) is a better indicator of whether monetary policy in that country is "tight" or "easy" than any inter-country interest rate differential. When monetary policy is tight in this sense (i.e. the yield curve is negatively sloped), the exchange rate is almost certain to be strong, and vice-versa - irrespective of so-called "fundamentals". But even the shape of the yield curve may not be an absolutely reliable indicator of the tightness or easiness of monetary policy because interest rates are only the price of credit, and as such they reflect the supply of and demand for loanable funds of different maturities, which is not the same as the real purchasing power (spendable money balances) of the community as a whole. The true fundamentals determining exchange rates are neither the trade balances nor the current balances nor the inflation rates nor the interest rate differentials nor the yield curves (which are all merely symptoms of credit conditions deriving from the current state of the business cycle), but rather the different relative monetary growth rates prevailing in different countries. It follows that if the apparent tendency for different factors to dominate foreign exchange markets at different times can all be comprehended within a monetarist framework, then a "monetary" approach to foreign exchange rate forecasting must have at least as good a chance of success as any other available techniques.

AUSTRALIA

CYCLICAL ADJUSTMENT REMAINS INCOMPLETE

The relative position of the Australian economy has changed substantially over the past year. During 1980 and 1981, real growth in the Australian economy typically exceeded that in other developed economies. Australia avoided the recessionary conditions which beset the majority of European economies, and the United States, over that period. Unemployment remained at a low level whilst real output rose by an average of nearly four percent between mid-1979 and mid-1981. The extended cyclical upswing was primarily the consequence of an unduly accommodative monetary policy.

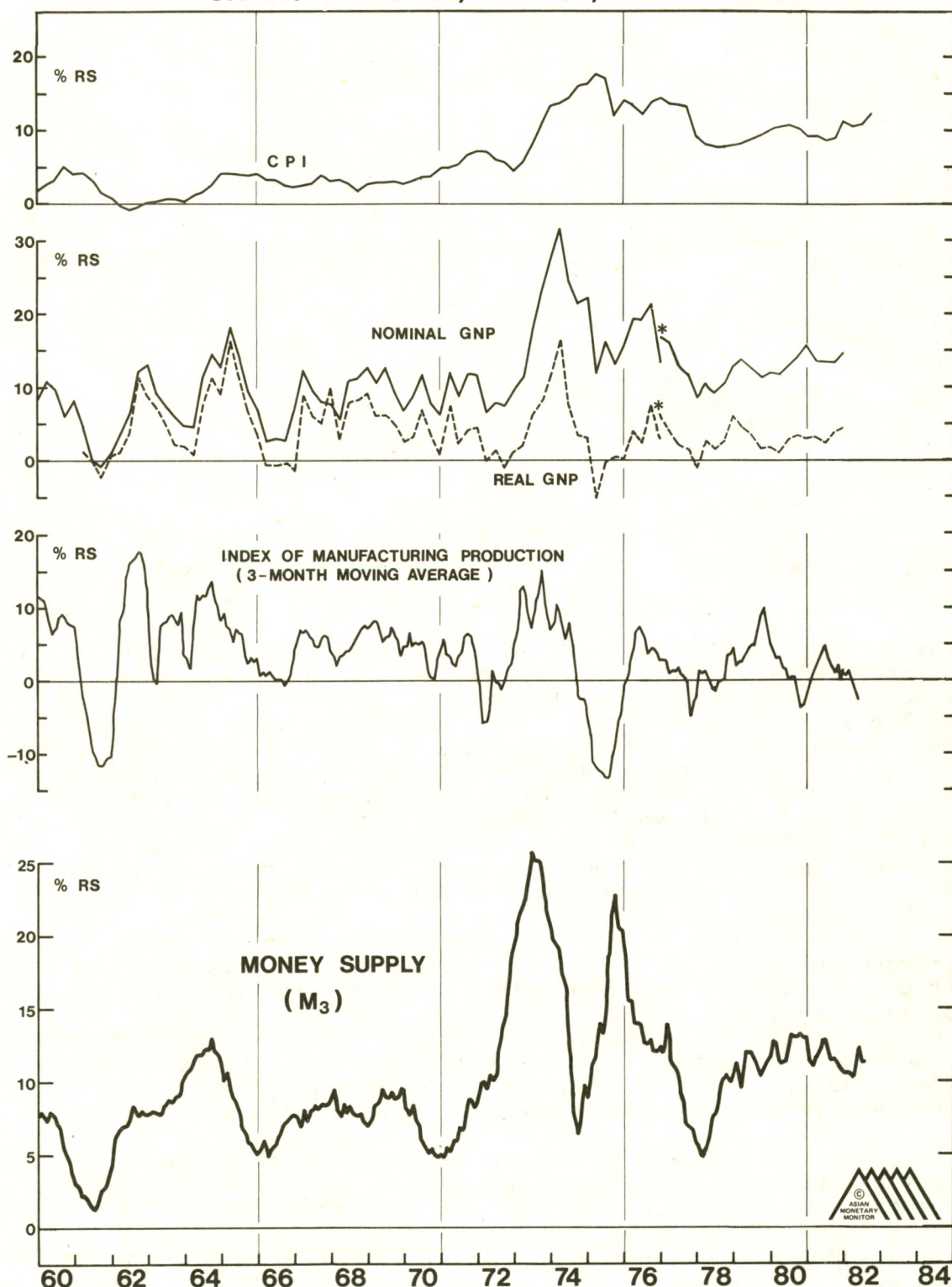
However by early 1981 many of the "costs" associated with the Reserve Bank's relatively easy monetary stance were becoming apparent. Initially the adverse consequences were more visible in the external sector of the Australian economy where both the trade and current accounts moved to sharp deficit. Nevertheless, the domestic economy did not remain immune to the deterioration in the external account. Balance of payments deficits throughout the second half of 1981 and the first three months of 1982 induced slower growth in Australia's monetary aggregates and tighter conditions in local money markets. Three month Treasury Bill rates rose from around 13% in August 1981 to over 19% in April 1982. Higher interest rates were a symptom of a growing squeeze in the domestic economy. With inflation persisting at high levels (see Chart 1) a moderate reduction in the year-to-year growth of M3 from 12.8% in June 1981 to 10.3% in March 1982 was sufficient to undercut real monetary growth. Real monetary growth may be thought of as a proxy for generalised purchasing power in the economy and, as may be seen in Chart 2, the fall in real M3 growth into the first half of 1982 proved sufficient to bring about a contraction in economic growth. With hindsight it is straightforward to view the autumn of 1981 as the cyclical peak in Australia's business cycle. Industrial production, as measured by the A.N.Z. Bank index of factory output has declined some 5% in the year to September 1982 whilst unemployment has soared to a post war high of 8.4% in October.

The onset of recession in Australia occurred between one and two years after real growth in most other economies started to falter.* One indication of the divergence between the Australian business cycle and trends in other countries

* In comparison with the U.K. the lag between the cyclical peak in each country's business cycle was considerably longer: the U.K. economy experienced negative real growth during the second and third quarters of 1979, fully three and a half years earlier than Australia.

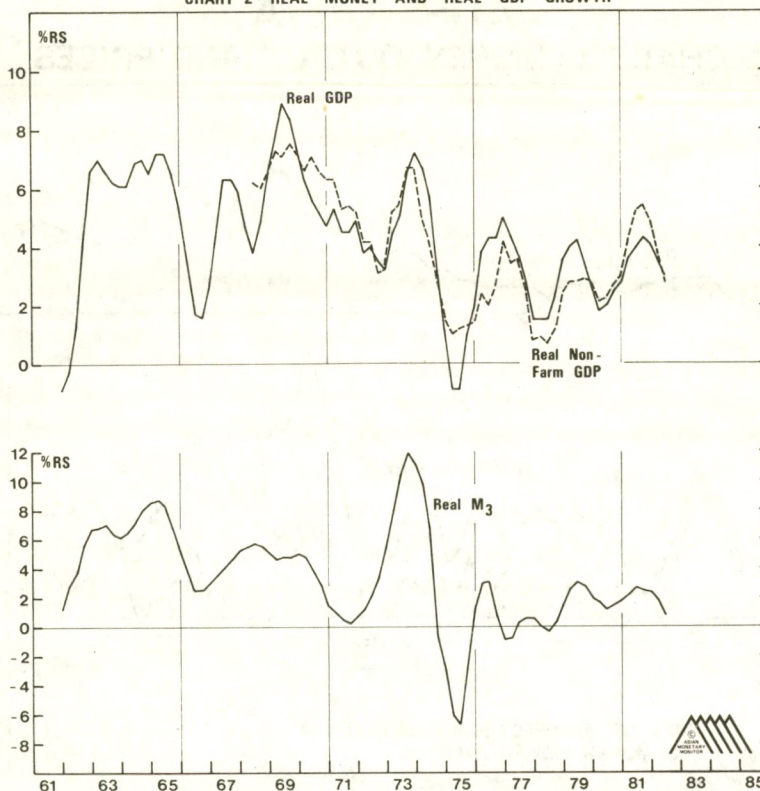
AUSTRALIA

CHART 1 : MONEY, OUTPUT, AND PRICES



*Change of data series.

AUSTRALIA
CHART 2: REAL MONEY AND REAL GDP GROWTH



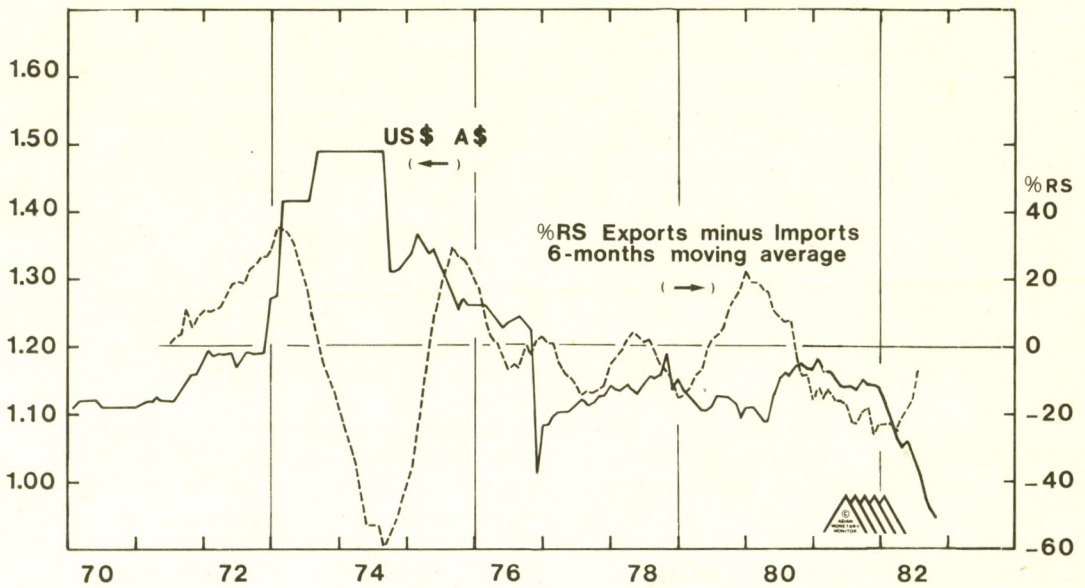
may be seen in the timing of cyclical peaks in short term interest rates. The United Kingdom's Minimum Lending Rate reached a cyclical high of 17% in July 1980. U.S. prime rates peaked at 21½% in December of the same year. The Bundesbank introduced the Special Lombard facility at a high of 12% in March 1981. In Australia, however, short term rates rose throughout 1980 and 1981 and reached their highest levels in April of this year. In addition, whilst economic activity continues to be weak in Australia, there are tangible indications of incipient recovery in other developed economies, notably the United Kingdom, Switzerland, the U.S. and Japan.

In recent months, however, there appears to have been an improvement in the prospects for Australia. The trend in the trade account is consistent with a moderation of the record deficits recorded over the past year. The trade deficit appears to have stabilised, and interest rates have registered spectacular declines at both the short and longer ends of the yield curve. Do these changes imply a meaningful near term recovery in the domestic economy?

Cyclical revivals in the Australian economy during previous business cycles have had certain general features in common. All earlier recoveries have been preceded by the combination of rising nominal monetary growth and declines in inflation and interest rates. Easier liquidity conditions in the domestic economy have typically been associated with an improvement in Australia's external position through the

AUSTRALIA

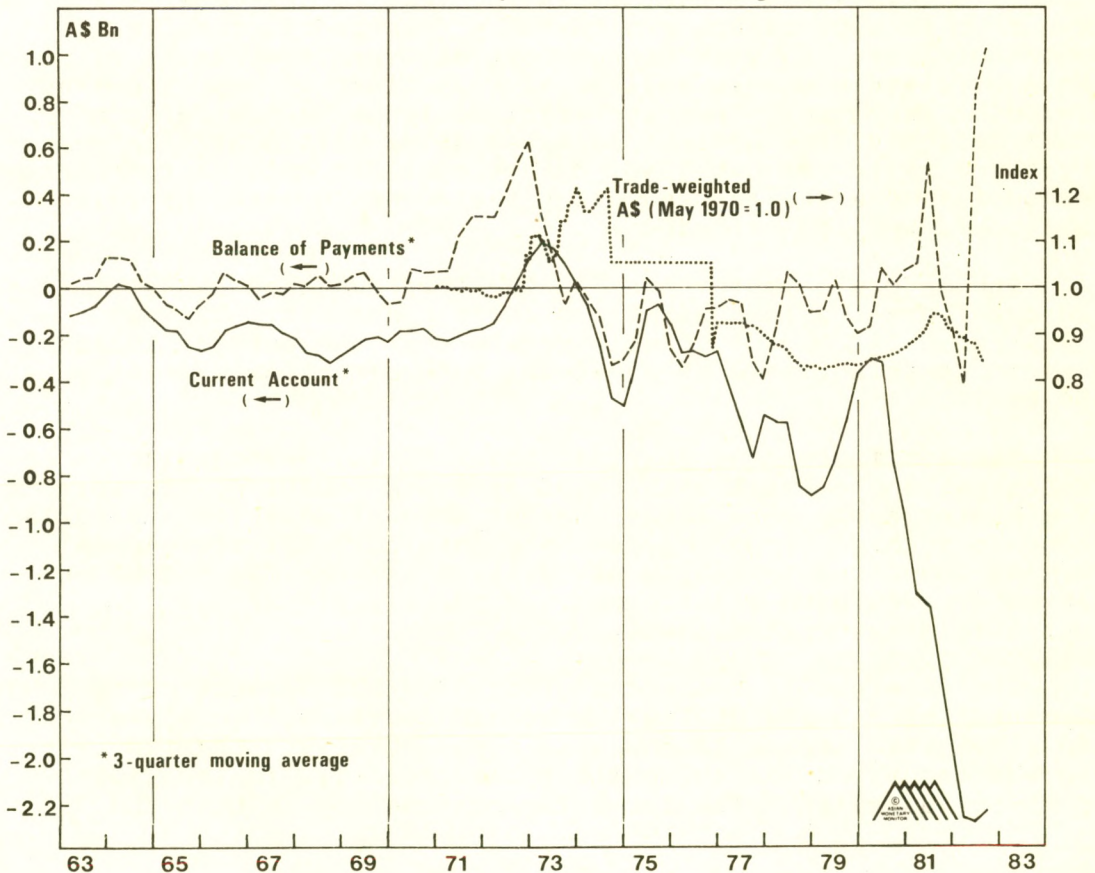
Chart 3 : The Trend in the Australian Trade Account



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Chart 4

Current Account, Balance of Payments and Trade-weighted Value of A\$



current account trending to surplus. The importance of the conjunction of rising nominal money growth and declining inflation is illustrated in Chart 2 which shows the trend in real M3 growth relative to that of real national income. It is apparent from Chart 2 that real monetary growth has been an important influence on the trend in the domestic economy. For example, the recovery in the Australian economy during 1975 was characterised by a number of fundamental changes typical of that stage in the business cycle. M3 soared nearly 20% that year whilst consumer price inflation dipped from 16.3% to 14.0%. The trend towards easier liquidity was encouraged by the decline in Treasury Bill yields from 10.75% to 7.19% during the course of the year and by a substantial improvement in both the trade and current accounts. Has the Australian economy now entered a similar period of cyclically easier liquidity of the form which would presage an economic recovery?

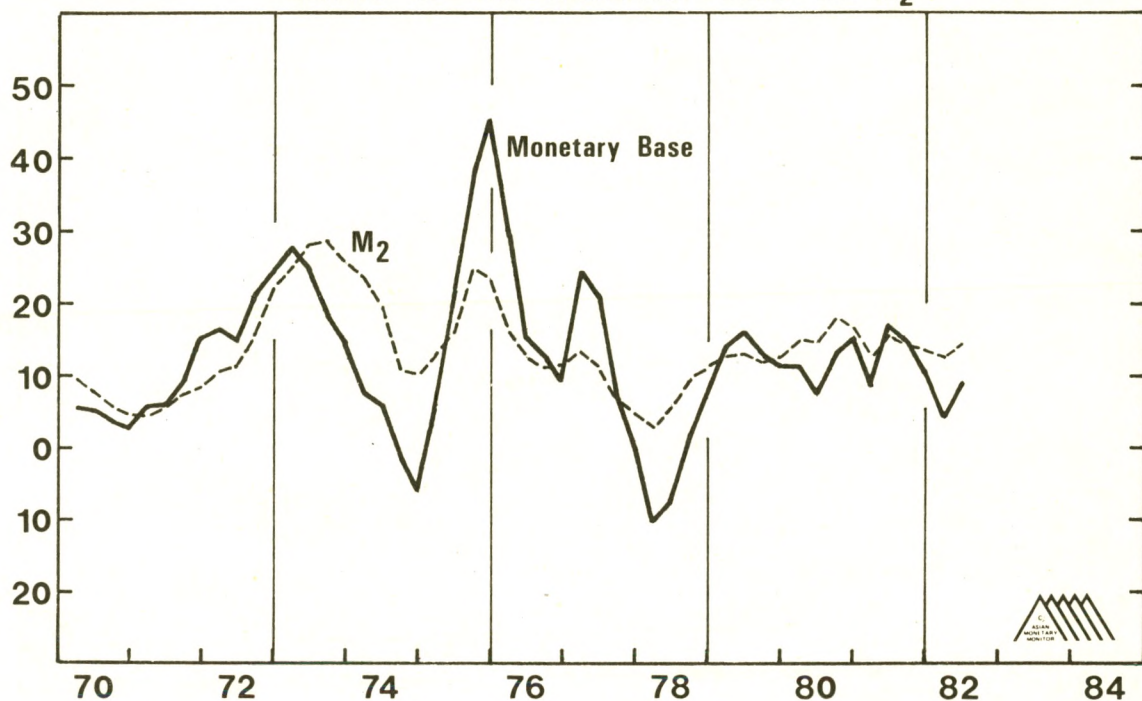
As mentioned above, some indicators offer grounds for encouragement. Chart 3 illustrates the underlying trend in Australia's current account by comparing the relative growth of exports and imports. (Both are measured in Australian dollars.) It is clear that a combination of depreciation in the Australian dollar and weakness in the domestic economy have reversed the deteriorating trend in the trade account. Export receipts rose roughly 15%, year-to-year during the third quarter of this year compared with a 7% decline during the final three months of 1981. Import growth, on the other hand, has moderated during the past six months. The value of imports rose by a relatively modest 4% in the year to September - well down from the 20% to 30% growth rates recorded in the final months of 1981. In view of the current overall weakness of the Australian economy, additional reductions in import demand are to be expected. Thus the small declines in Australia's trade deficits (the deficit measured A\$782 million in the three months to October 1982, down from A\$869 million in the same period last year) witnessed since the second quarter of this year could well be extended.

The moderate improvement in the trade balance has stemmed the deterioration in Australia's current account. This is illustrated in Chart 4 which suggests that the current account deficit has stabilised at an annual rate of approximately A\$9 billion.

The key feature of Chart 4, however, is the huge increase in Australia's overall balance of payments position. In spite of a historically very large current account deficit, Australia enjoys a record balance of payments surplus. Private capital inflows amounting to nearly A\$9 billion between March 1982 and September 1982 have transformed the overall picture of Australia's external account.

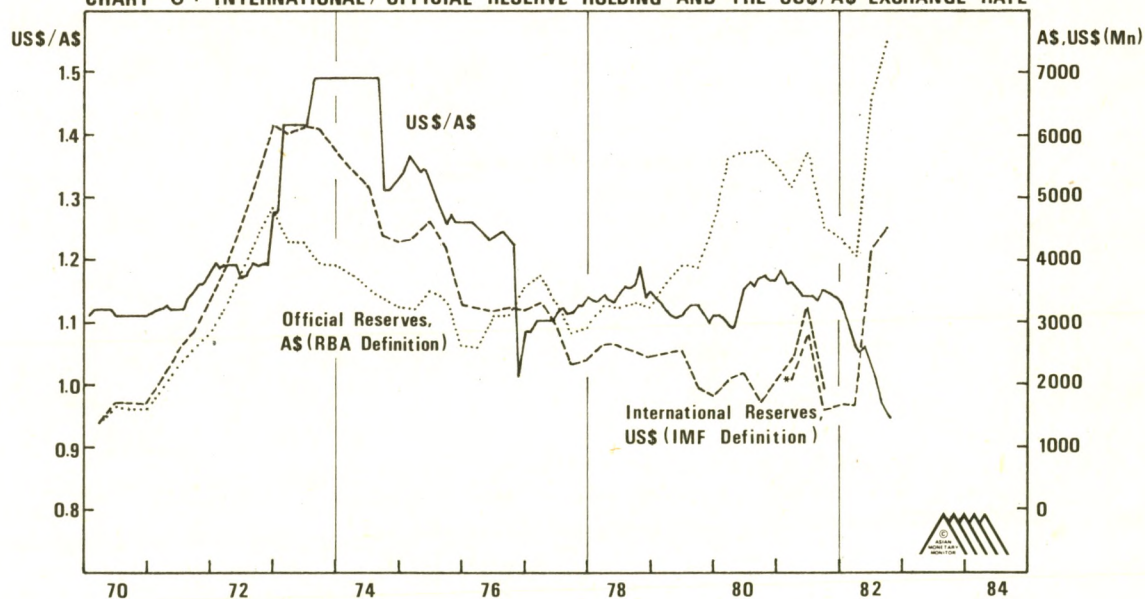
The reversal in the trend of the overall balance of payments which began during the second quarter of this year has had a dramatic impact on domestic money markets. Chart 5 records the trend in the monetary base relative to the growth of M2 in Australia. The irregular contraction in both the

AUSTRALIA : CHART 5 IMPACT OF THE MONETARY BASE ON M₂



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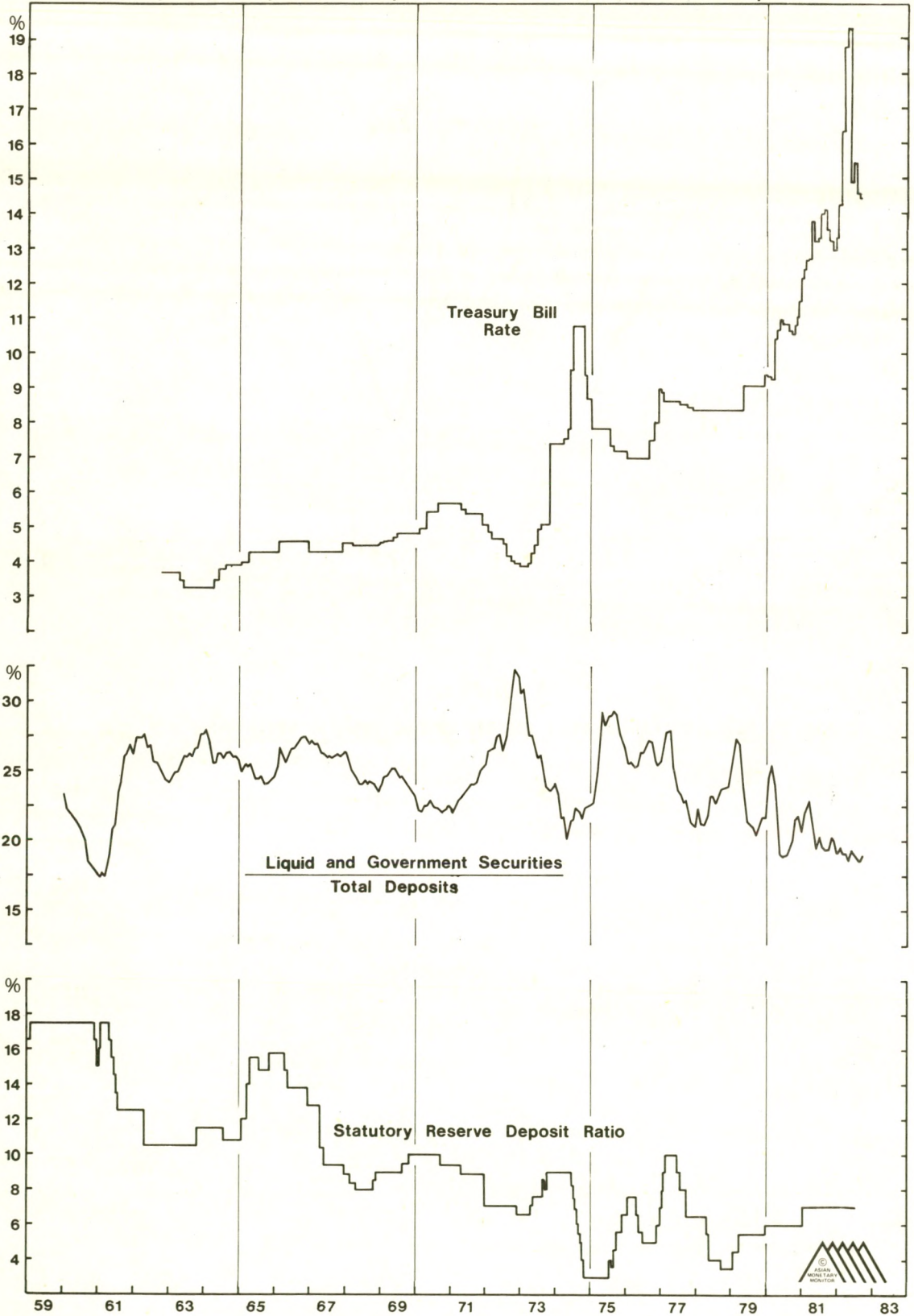
CHART 6 : INTERNATIONAL / OFFICIAL RESERVE HOLDING AND THE US\$/A\$ EXCHANGE RATE



* Excludes valuation changes in official gold holdings

AUSTRALIA : CHART 7

Statutory Reserve Deposit Ratio, Liquid and Government Securities and Treasury Bill Rate

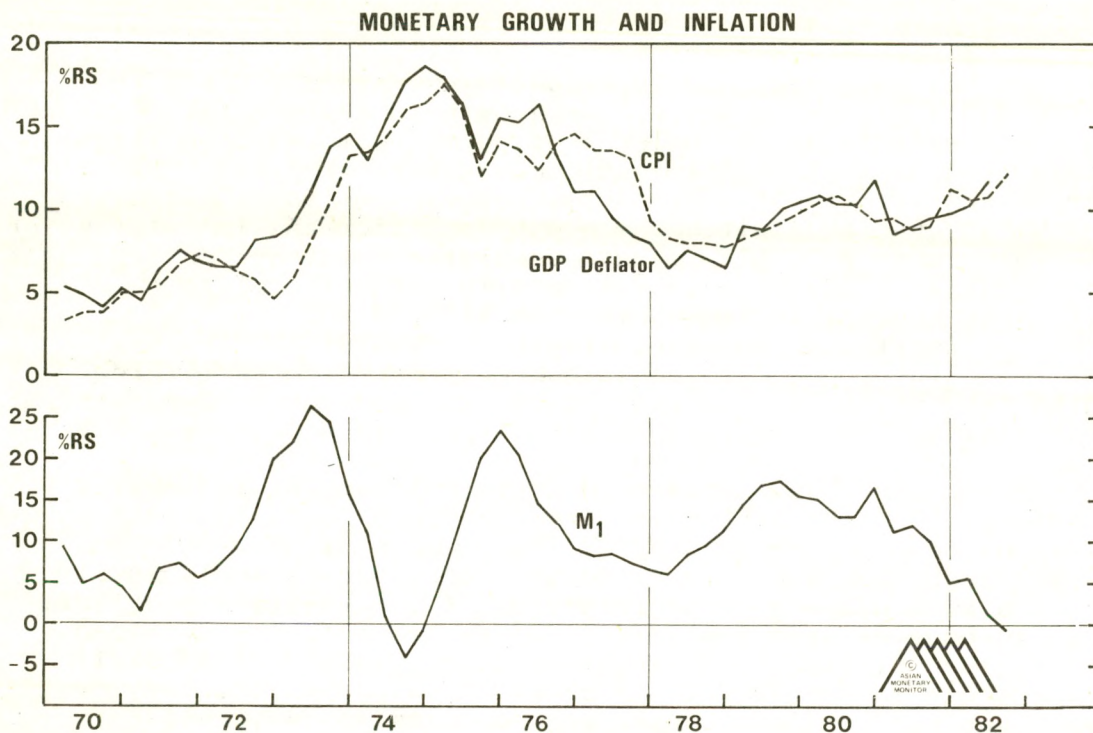


growth of the monetary base and the growth in M2 during the period between July 1980 and March 1982 is displayed on the Chart. This period of contraction coincided with an overall balance of payments deficit and an associated fall in Australia's International Reserves, as is evident in Chart 6. Since the spring of this year, however, the growth in the monetary base has risen sharply as the balance of payments moved to a large surplus and Australian International Reserves soared. The year-on-year growth of the monetary base rose from 4% in March to 8.9% in June and, given the additional increase in International Reserves, is very likely to have accelerated further during the third quarter although official data is not yet available. Thus large capital inflows have been allowed to form the potential for faster monetary growth in Australia. Trading Banks' liquidity has also eased somewhat over the past three months (see Chart 7) with the Liquids and Government Securities ratio rising above 20% for the first time since October 1981.

The Reserve Bank's response to recent capital inflows is important. Had the Australian dollar been allowed to float freely on the foreign exchanges, the balance of payments surpluses on the scale witnessed in recent months would surely have led to a measure of appreciation of the Australian dollar. As it is however, the Australian dollar has actually declined against the official trade-weighted index, falling from 88.1 at the beginning of July to around 84 now. The corollary of the Reserve Bank's decision not to allow the Australian dollar to appreciate has been the large rise in International Reserve holdings and an associated boost to growth in the monetary base. Virtually the entire increase in the monetary base since the first quarter of 1982 has been derived from the balance of payments, or foreign exchange, source of the base. Effectively, therefore, the Reserve Bank's policy has been to manage the Australian dollar during a period of balance of payment surpluses with a view to forcing domestic interest rates lower. Such a policy is asymmetric to the one pursued during the fourth quarter of 1981 and the first half of 1982, when the balance of payments was in deficit, or registered smaller surpluses than at present. During that period the Reserve Bank allowed the Australian dollar to depreciate against the trade-weighted index in an attempt to stem the decline in International Reserve holdings and alleviate even greater upward pressure on interest rates.

In effect, the Reserve Bank has managed the exchange rate in the way most conducive to lower domestic interest rates: Herein lies the rub. The impact of the Reserve Bank's policy has been to allow monetary growth to continue to expand at an excessive pace. The recent decline in interest rates has only been achieved at the cost of laying the foundation - through an increase in the monetary base and an easing in Trading Bank liquidity - for further increases in growth of the monetary aggregates.

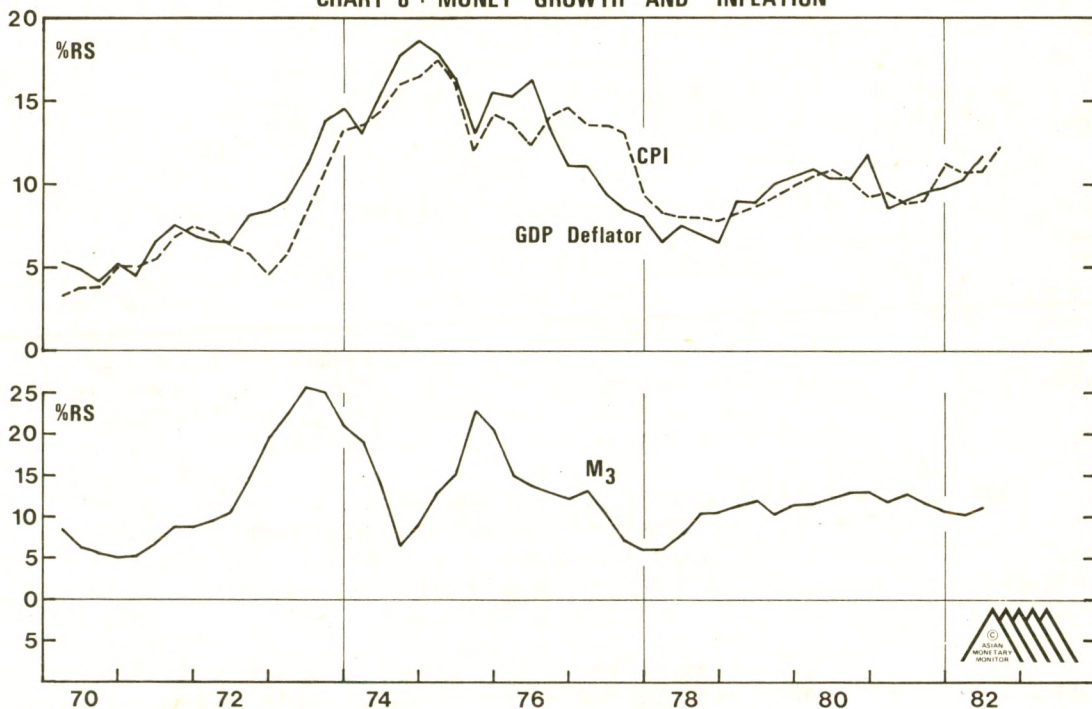
Chart 8 records the relationship between the year-to-year increase in M3 and the annual rate of change in consumer prices and in the GDP deflator. It reveals the typical relationship



Although the growth rate in M3 has remained relatively stable, and high, during the past three years, M1 has exhibited a different trend. As is evident from the chart above the year-to-year peak in M1 growth occurred in the second quarter of 1979, at 18.2% with a further spike during the fourth quarter of 1980. Since that time M1 growth has plummeted, with M1 declining 0.6% in the year to July 1982. Does the trend in M1 imply that monetary policy has actually been significantly tighter than is suggested by the trend in M2 and M3?

It seems likely that a number of factors have led to M1 being an unrepresentative monetary indicator during the past year. First, sharply higher short term market rates during this period have in themselves created a considerable incentive for depositors to shift towards higher yielding assets, in this case a switch into time and savings deposits from demand deposits which are included in M1. In March 1982, the ceiling on Trading Bank savings deposit rates was lifted from 13½% to 14½%, the first such increase in nearly eighteen months. The impact on the public's holding of demand deposits was considerable. Between March and May 1982 demand deposits at all Trading Banks fell by more than 9%, leading to an absolute decline in seasonally adjusted M1 in excess of 5% during the second quarter. Slower growth in M1 could also reflect institutional changes in the Australian Banking system. M1 includes cash currency and demand deposits at Trading Banks, but it does not include demand deposits at certain other financial institutions. For example, money market funds were started during the past year and are managed mainly by brokerage houses. Their total assets amount to only about A\$1.5 bn. (compared with M1 of A\$17 bn.), but it is possible that money market funds and the Trading Banks offer services which are partial substitutes for one another. The growth in money market funds is likely therefore to have marginally curtailed growth in M1.

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CHART 8 : MONEY GROWTH AND INFLATION



between monetary growth and inflation, with broad swings in inflation lagging the course of monetary policy by between one and two years. It is evident that there has been no significant decline in monetary growth in Australia, in spite of high nominal interest rates and large current account deficits. On the basis of the recent trend in monetary growth it is unlikely, even against the backdrop of a weak domestic economy, that inflation will drop below 10% over the coming year. It is the likelihood of continuing relatively high levels of inflation and the Reserve Bank's failure to reduce monetary growth which are the main reasons for doubting that cyclical adjustment in the Australian economy is complete.

Since inflation is likely to remain close to present levels a recovery based on a rise in generalised real purchasing power in the Australian economy at this stage will likely only occur if the Reserve Bank tolerates higher monetary growth. Whilst the longer term consequences of such a policy would undoubtedly lead to higher inflation, it could stem the recent decline in economic activity.

Nevertheless, there are two broad problems with this approach. First, even a modest revival in the Australian economy following higher monetary growth would undermine the modest improvement evident in the current account deficit. Second, liquidity growth in the Australian economy remains primarily dependent on the level of private and official capital inflows. In the event of the overall balance of

payments moving to deficit a tenuous revival in the economy could only be sustained if the Reserve Bank sanctioned a sharp depreciation in the Australian dollar. Otherwise a drain on Australia's International Reserve holdings would induce a contraction in the monetary base, a monetary squeeze, and a further period of recession.

FORECAST: The Australian economy is likely to continue to suffer "stagflation" during the coming year. The Reserve Bank will not, we feel, sanction a sufficiently easy monetary policy to induce a revival in economic activity. To do so would be to invite a further rise in inflation and inflationary expectations, and to risk a reduction in the level of capital inflows. However, one should not anticipate a significant slowdown in monetary growth at the present time. Slower growth in M3 whilst the balance of payments remains in large surplus could only be achieved through a combination of an appreciation in the Australian dollar and/or a rise in local interest rates. Any appreciation of the Australian dollar would only further undermine Australia's poor level of international competitiveness and it would seem unlikely that the Reserve Bank would wish to exacerbate pressure on the current account.

Ultimately, of course, the Australian economy will have to adjust to the trend towards lower inflation evident amongst its trading partners. It is likely that this adjustment - via slower growth in the monetary aggregates - will occur as and when the overall balance of payments moves to deficit, reflecting the large deficit on current account. As this occurs, Australia will suffer a further decline in the level of economic activity. The Reserve Bank may try to alleviate this by depreciating the Australian dollar, but the longer term outlook for the Australian economy remains poor.

SPECIAL ARTICLE

DEPOSIT INSURANCE FOR HONG KONG : A TENTATIVE PROPOSAL

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This is a note on the lessons that should be drawn from recent incidents in Hong Kong's financial sector, namely the sudden collapse of the Tse Lee Yuen chain of jewellery companies and the run on Hang Lung Bank. Both were unfortunate in that they inevitably tarnished the image of Hong Kong as a financial centre. However, the Hang Lung incident was more serious in terms of its potential chain reactions affecting the whole financial system.

Since the 1965 banking crisis that shook the whole system to its very foundation, there have been so far two bank runs: one was the run on Sun Hung Kai Finance Co. (the predecessor of Sun Hung Kai Bank) in 1978, and the other was the recent run on Hang Lung Bank. Both were incidents touched off by irresponsible, and perhaps malicious, rumours. However, the fact that such runs should have occurred at all is profoundly disturbing, considering the enormous improvements that have taken place in both regulatory framework and bank portfolio management since 1965.

As Friedman [2, chap. III] has convincingly argued, a fractional reserve banking industry is "inherently unstable" in the sense that no bank, however soundly managed, can withstand a sustained run without governmental intervention or an organized rescue operation by other banks. This is especially true here because of the lack of any formal built-in stabilizer. It is perhaps typical of Hong Kong that, whenever there is a downturn in one particular sector (e.g. the property market) or in the economy as a whole, rumours will circulate about the alleged difficulties of this or that bank or finance company. The average Hong Kong depositor or investor, unfortunately, is not noted for his deep knowledge of economic and financial affairs, and is consequently an easy prey to all kinds of hearsay. Since Hong Kong's bank runs (in 1961, 1965, 1978, and 1982) all follow a familiar pattern, the question naturally arises as to whether the territory is not in some sense panic-prone.

Although the run on Hang Lung Bank quickly subsided after support was pledged by the Government and some leading banks (including, interestingly, the Bank of China), there is no guarantee that similar runs will not recur in future. Indeed, it is not inconceivable that, should the present slump in the property market continue for any length of time, quite a few DTCs would find themselves in serious financial trouble, and this in turn could trigger off another panic. However, it

would be wrong for us to strike a superior attitude and condemn the behaviour of the crowds queueing outside bank offices as "irresponsible". Since there is no explicit guarantee of the safety of deposits in banks or other depository institutions, such deposits are, rightly or wrongly, regarded as risky, and the propensity to convert them into cash at the first sign of trouble is not, at least from the purely selfish standpoint, irrational. A rescue operation is effective only when mounted immediately after a bank run occurs; when the run is already spreading from one bank to another, it will be much more difficult to control. More important, any remedial action taken on an ad hoc or post hoc basis is, of course, inherently inferior to an institutional arrangement which prevents bank runs from starting at all.

Thus it is incumbent upon the monetary authorities, as well as economists both inside and outside the Government, to devise a panic-proof system which removes the motivation for bank runs. It is in this spirit that the present paper is prepared for serious discussion and consideration by all who are concerned about the stability of Hong Kong's banking and financial system. A deposit insurance scheme has been suggested for Hong Kong in the past ([7], p. 282; [8], p. 48), but it is time to take another hard look at the proposal in the light of recent events.

It may be useful to give a sketch of deposit insurance elsewhere as background information. Historically, deposit insurance was experimented within some American states in the last century, but Czechoslovakia was reported to be the first country to introduce it on a nationwide basis in 1924([10], [12]). However, it is universally agreed that the most comprehensive and successful insurance scheme is that run by the U.S. Federal Deposit Insurance Corporation (FDIC). The FDIC was established in 1934 after the catastrophic banking crisis during the Great Depression of 1930-33, which saw the closure of some 9,000 banks, most of which, according to Friedman and Schwartz, were basically sound. Initially the maximum level of deposits insured for each account was fixed at US\$5,000, but this was later raised to US\$40,000 in 1974 and again to US\$100,000 in 1980. The success of FDIC can be shown by the fact that from 1934 to 1977, only 541 banks failed (none caused by bank runs), and 99.8% of depositors were fully compensated. To quote Friedman again ([1], p. 38) "federal deposit insurance has performed a signal service in rendering the banking system panic-proof". The introduction of the scheme was also "the most important structural change in our monetary system in the direction of greater stability", (p. 21). More or less the same statement is repeated in Friedman and Schwartz ([3], p. 434).

Perhaps the most flattering evidence is that the FDIC model has inspired similar schemes in other countries. As of 1980, 12 countries other than the U.S. have adopted deposit insurance in one form or another: Argentina, Canada, Chile, West Germany, India, Japan, Netherlands, Philippines, Turkey, United Kingdom, Spain ([12]). The United Kingdom has been rather late in adopting the scheme: the British banking system

used to pride itself on the fact that no single bank failed even in the Great Depression of the thirties, and tended to dismiss the scheme as irrelevant. However, in 1973/74 a serious crisis broke out in the fringe banking sector, and the Bank of England had to organize hastily a rescue operation (the "Lifeboat") to prevent the panic from becoming system-wide. Since then the need for a deposit insurance scheme has been widely recognized, though the London clearing banks have accepted it only grudgingly ([16] chp. 5). The Banking Act of 1979 provides for a Deposit Protection Fund, which was set up in the following year. Under the scheme, a depositor is entitled to reimbursement equal to three-quarters of his protected deposits, limited to a maximum of 10,000. Insurance premia takes the form of contributions levied from time to time on member institutions ([19] Part II).

The pros and cons of deposit insurance may also be briefly reviewed here. The principal argument for deposit insurance is that it ensures the stability of the banking and financial system by removing the motives for starting bank runs. Since the safety of deposits is guaranteed, there is no point in depositors withdrawing cash prematurely. As is well known, the most pernicious effect of a panic is that it strikes down sound financial institutions along with the unsound. Apart from this principal reason, there are other important, though perhaps less well-known benefits. First, once deposit insurance is introduced, depositors will be indifferent between large and small banks (as long as they are perceived to be equally well-managed), and as a result, entry will become easier and competition keener, leading to higher efficiency and better services all round. Furthermore, in the absence of deposit insurance, inefficient or poorly managed banks are often shielded by regulatory authorities for fear that their closure might touch off a panic. With deposit insurance, such inhibitions are no longer justifiable: market discipline should prevail, and unsound banks will be allowed to fail, without any ill effects ([16], [17]). Second, since depositors no longer switch from the smaller to the larger banks as long as they are equally efficient, deposit insurance will also help to lessen the degree of concentration in the banking industry, which is notoriously oligopolistic. This is highly desirable from the distributional equity point of view, quite apart from the fact that deposit insurance primarily protects the less affluent members of the society. Third, depositors are spared large information and surveillance costs if the safety of bank deposits is assured without the need to undertake tedious research on bank management and financial conditions.

Criticism of the scheme generally centres on the administrative and other costs which may be unacceptable to the member institutions or the taxpayers. The validity of this objection has to be evaluated on the basis of a careful cost-benefit analysis. The benefits of a stable and panic-proof banking system are not easily quantifiable, but on both theoretical and empirical grounds, they can be shown to be immeasurably greater than the costs of the insurance scheme. Even from the purely pecuniary point of view, the costs are not

as high as generally imagined. The U.S. data suggest that the direct costs of the FDIC typically constitute 0.0129 per cent of insured deposits ([12]), while a theoretical estimate of the "normal" case suggests an insurance cost of 0.0006 per dollar of insured deposits, on the reasonable assumption that the deposits-assets ratio is 0.9 and the variance of asset value is 0.003 ([13]). Moreover, the insurance fund is invested in interest-bearing securities, typically Treasury bills, and the surplus of income over costs is returned to the contributory institutions as dividends or rebates, or to the Treasury as public revenue. In Hong Kong, we have a precedent in the Hong Kong Export Credit Insurance Corporation, which has been operating successfully and profitably since 1966. If export credit insurance can be viable, why can't deposit insurance?

A more serious objection is, in my view, based on "moral hazard", an important concept in the economic theory of insurance ([16]). In the context of our problem, this essentially means that, once deposits are insured, bank management might become less prudent in granting loans and in other activities. In technical jargon, if bank liabilities are insured at a premium that is independent of portfolio risk, then banks would tend to hold the riskiest portfolios they are allowed to hold. The point is well taken. However, moral hazard per se does not overthrow the case for deposit insurance, since the hazard can be minimized by not relaxing prudential control and regulation. In other words, deposit insurance is a complement of, and not a substitute for, the prudential supervision of all depository institutions. As a further precaution, some scholars have suggested that the insurance premium be positively linked to the riskiness of the bank portfolio ([11]), though this of course raises the thorny problem of how to define riskiness of bank assets fairly and correctly. Finally, moral hazard is not unique to deposit insurance: it is present in every form of insurance, life and fire insurance being the most obvious examples. Yet no reasonable person has seriously argued that such forms of insurance are harmful or unnecessary.

If it is agreed that there is a good case for deposit insurance in Hong Kong, the next question is how it should be set up. It is proposed that a special commission, consisting of government officials, bankers, economists and representatives of commerce and industry, should first be established to consider the matter. The details need not detain us here, but some general principles can be briefly discussed under the following headings:

(a) Organization - As already mentioned, the Hong Kong Export Credit Insurance Corporation can serve as a handy organizational model. This statutory body is entirely government-owned, but there is no reason why the initial capital of the proposed Hong Kong Deposit Insurance Corporation (HKDIC) should not be jointly subscribed by the Government, the licensed banks, and the licensed and registered DTCs.

(b) Membership - In principle, membership should be compulsory for Hong Kong-incorporated banks and DTCs. This is

consistent with the general practice elsewhere. Most foreign entities however will probably also join in order not to lose Hong Kong dollar deposits to the insured institutions.

(c) Coverage - The HKDIC will insure Hong Kong dollar deposits with all member banks and DTCs up to a maximum of, say, HK\$100,000 for each account. Under present circumstances, this should be adequate to protect the deposits of most middle and lower income groups. The ceiling can of course be raised in accordance with changing needs. Foreign currency deposits should not be insured.

(d) Financing - Apart from the initial capital, the HKDIC will have to rely for its regular income on insurance premia. The determination of an appropriate level of premium is a delicate matter, and must be handled with great care. The following hypothetical example merely serves as an illustration of the order of magnitude involved. As at the end of July 1982, total deposits with banks and DTCs amounted to some HK\$129.3 billion. Assuming that half of them, i.e. about HK\$64.7 billion, are insured, and further assuming an annual premium of 0.05 per cent on the insured deposits, then total premium will be of the order of HK\$32.4 million per annum. Since this will be shared in proportion to the deposit base of some 484 banks and DTCs, the burden on each member institution can only be described as eminently reasonable, especially when one recalls that profits of the scheme, net of operating costs and payoffs, will be returned pro rata as dividends or rebates to member institutions. Like other statutory bodies, the HKDIC should be given legal powers to borrow up to a specified amount.

(a) and (b) above are straightforward, but (c) and (d) could be potentially contentious. The rationale for a cut-off point in insured deposits is that, whereas the less affluent depositors should be protected, the wealthier ones should observe the market principle of caveat emptor. This view has however been disputed by some economists in recent years, arguing that rich but uninsured depositors could also start a panic by withdrawing their accounts via the clearance system. In practice, deposit insurance schemes in many countries operate in such a way that even the uninsured deposits are protected. Thus, the FDIC, through a procedure known as "purchase and assumption" --- selling the "good" part but assuming the "bad" part of a failed bank --- in effect provides 100 per cent coverage of all deposits. However, the U.K. practice of repaying only 75 per cent of insured deposits is most unusual. This partial reimbursement is probably a concession to the powerful London clearing banks, which strongly opposed the original idea of a deposit protection scheme. ([16], chp. 5). I personally feel that such a practice is most unfortunate; if the proposed deposit insurance is to succeed in Hong Kong, it must undertake full repayment of insured deposits.

One pertinent question which the reader might ask is: are there any alternatives to deposit insurance which serve the same purpose? From time to time, scholars and practitioners have

indeed suggested other schemes to achieve a panic-proof banking system. An earlier and perhaps the most famous one was the "100 per cent reserve plan" advocated mainly, but not exclusively, by the Chicago School of economists in the 1930s ([5]). However, in this plan the elimination of bank runs was subsidiary to the attainment of truly effective monetary control as the real substance of the argument. The main difficulty with this plan was that it would deprive the banks of their ability of granting loans--universally regarded as their principal economic and social function--and hence of earning a living. Bank capital could presumably be used for credit creation, but this would be most imprudent, defeating the very purpose of the plan. In theory, the ultimate lenders and borrowers could still be brought together, with the banks acting as no more than "honest brokers", but the increase in transaction costs would be horrendous. There can be no doubt that there is an inherent risk in "multiple credit creation" and "maturity transformation", but it is also undeniable that the advantages of a fractional reserve system, such as economies of scale, efficiency and convenience, are very considerable.

A modified plan would be to require a 100 per cent reserve against demand deposits only, but not against savings and time deposits. This would be equivalent to a significant rise in average reserve requirements. As pointed out by many economists, raising the reserve requirement is like raising the tax on bank earnings, unless the Government is willing to forego the seigniorage by equivalent subsidy to the banking system. For these various reasons, no country, with the exception perhaps of those in the Communist bloc, has found it possible to adopt the plan.

Another alternative is credit insurance or loan guarantees, under which bank loan portfolios are insured against default or other losses. This plan provides only indirect protection to the depositors, and is therefore less effective in preventing bank runs. However, some countries, such as West Germany and India, provide credit insurance in conjunction with deposit insurance.

Still another suggestion is a capital adequacy plan. The idea is that banks and depository institutions should be required to increase their equity capital pari passu with their assets or deposits, so that the capital/assets or capital/deposits ratio be always kept at a fairly constant and prudential level. While there is considerable merit in this proposal, a bank's equity capital essentially serves as an ex post absorber of losses. A high capital ratio, like credit insurance, is psychologically less effective than deposit insurance in forestalling a bank panic. In the words of a distinguished central banker, "bank capital is essentially self-insurance; insurance provided by the Federal Deposit Insurance Corporation is pooled insurance" ([20]), p. 230). Consequently, the capital adequacy test is used by many countries, including the U.S., as a supplement to, rather than as a substitute for, deposit insurance.

Finally, what may be called a "full-information solution" is vaguely implied in recent writings of the "rational expectations" school ([9]). Roughly, the suggestion seems to be that, if only the banks and near-banks are willing to disclose fully the details of their true financial condition, especially those pertaining to their loan portfolios, and if the depositors are prepared to pay a price for such information (in terms of money and search efforts), then because both sides act "prudently" in the sense that their behaviour conforms to their preferences (e.g. a risk-loving depositor "chooses" an aggressive bank), there will be no bank panic. Although theoretically elegant, there is unfortunately little operational value in this proposal. Bankers everywhere are by their professional training highly secretive; in Hong Kong especially, bank statements are virtually useless to depositors. It is also doubtful whether the average depositor has the time and ability to undertake the independent research required by the model. At the same time, the regulatory authorities, which presumably have greater access to information, are also unwilling to disclose confidential details to the public. Thus in Hong Kong, the Banking Commissioner's Office would not even allow independent scholars to look at the monthly returns filed by banks and DTCs.

Having examined all possible alternatives, one can only conclude that, on both theoretical and empirical grounds, deposit insurance is the only feasible device that can ensure the long-term stability of the banking and financial system. It is to be emphasized that, for such a scheme to be truly effective, it must be buttressed by a framework of stringent prudential regulations.

The case for deposit insurance is even stronger when seen from a wider perspective. In the United States and United Kingdom, for example, the level of economic education of the general public is much higher, the banking and financial structure is much better developed and sophisticated, and the Federal Reserve and the Bank of England, with their formidable resources, are always ready to act as a statutory lender of last resort. Even so, there is a need for deposit insurance in both countries. It is difficult to believe that deposit insurance is unnecessary in Hong Kong in the light of our record of bank runs, and certain well-known deficiencies and lacunae in our financial structure.

It is of course quite possible that the larger banks with entrenched market shares will oppose the scheme from a selfish standpoint. One is reminded of the fact that, when the FDIC was first proposed, the American Bankers Association, dominated by the major "money-centre" banks, violently attacked it as "unsound, unscientific, unjust, and dangerous" (quoted in [4], pp. 196-97; and [14], p. 443). History's verdict is, however, exactly the opposite.

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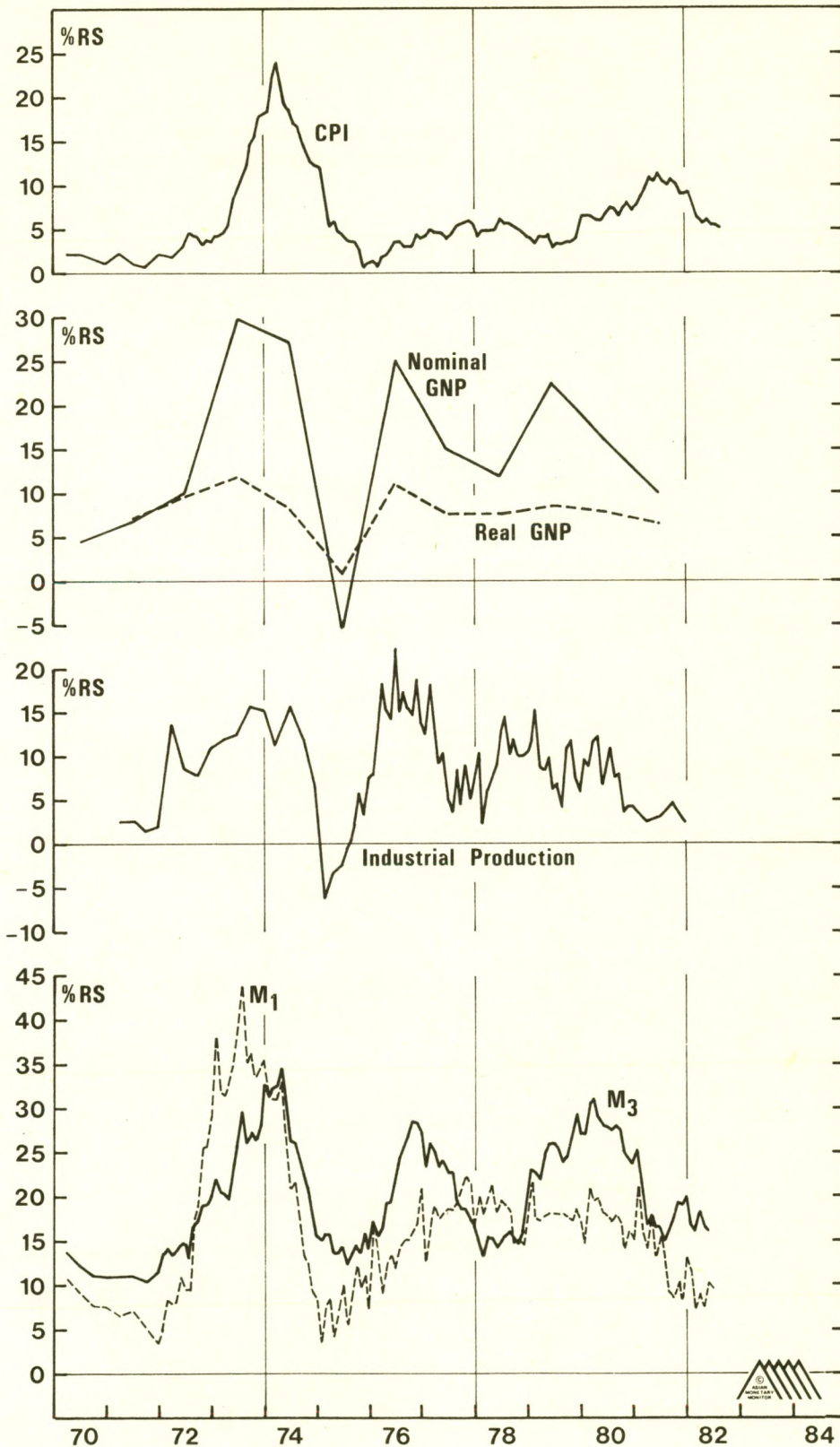
ANOTHER OVER - OPTIMISTIC BUDGET

The Malaysian budget for calendar 1983 which was announced on October 22 has been represented as a sharp reversal of the expansionary counter-cyclical fiscal policies that were put in place to steer the economy through recession and attain the targets of the current five year plan. However, although it is true that when compared to the original 1982 budget the new budget does look tight, in terms of a comparison with the actual level of expenditures reached this year, rather than budget allocations, the difference in fiscal stance is in fact not so marked. This is largely due to the mid-year expenditure cutbacks in the development budget that became necessary as government revenues fell below expectations, in the wake of sharp declines in the prices of palm oil, tin and rubber and the weakness of the domestic economy.

Considering the actual numbers, the 1983 budget allocation for development expenditure, of M\$11.67 bn., represents a 20% cutback from the M\$14.63 bn. originally allocated for development in last year's budget. When taken together with a roughly unchanged level of operating expenditure, the total government expenditure of M\$28.75 bn. budgeted for 1983 represents as much as a 10% drop from the total expenditure originally budgeted for last year. However, when actual, rather than budgeted, expenditure levels are considered 1983's expected total government expenditure represents a rise of 1.4% over this year's expected level. The budget deficit is nevertheless expected to decline in size - from M\$10.2 bn. this year to M\$8.48 bn. next year - due to an anticipated pickup in government revenues. However, a M\$8.48 bn. deficit still represents 14% of GNP and as such cannot be considered fiscally contractionary.

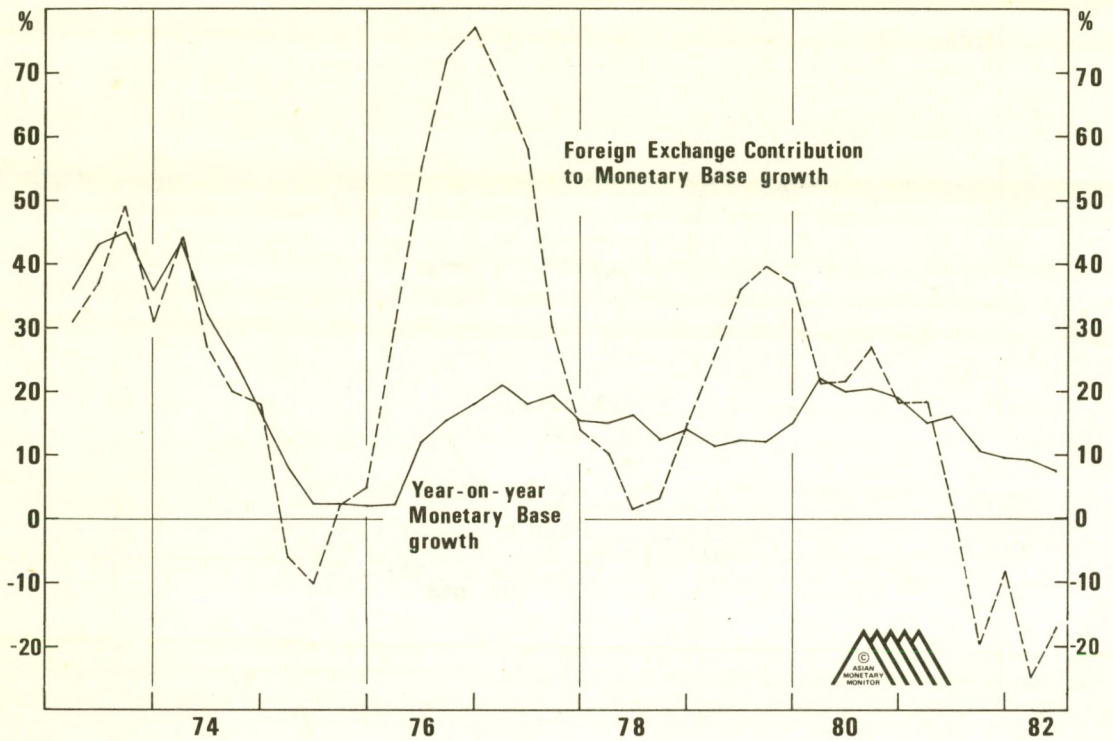
Malaysia's fiscal policy must be viewed in conjunction with its monetary policy. In theory there are two policy options with regard to exchange rate and monetary management which any monetary authority can take to ensure long run stability in economic growth and inflation with an equilibrium balance of payments: either it can fix monetary growth but allow its currency to float freely on the foreign exchanges or it can peg its currency to the currency of a country with a low and stable inflation rate. In the first case the burden of any adjustment to external change is placed on the exchange rate and it is up to the monetary authority to choose an appropriate rate of monetary growth to ensure stable non-inflationary growth, as the foreign component of monetary growth will necessarily be zero. In the second case the burden of adjustment falls upon monetary growth and domestic demand. A contraction in external demand will lead to a balance of payments deficit and hence a decline in monetary base growth. This in turn will result in a decline in the demand for imports as well as lower inflation and hence increased export competitiveness which will take the balance of payments back to equilibrium.

MALAYSIA
CHART 1 : MONEY, OUTPUT AND PRICES

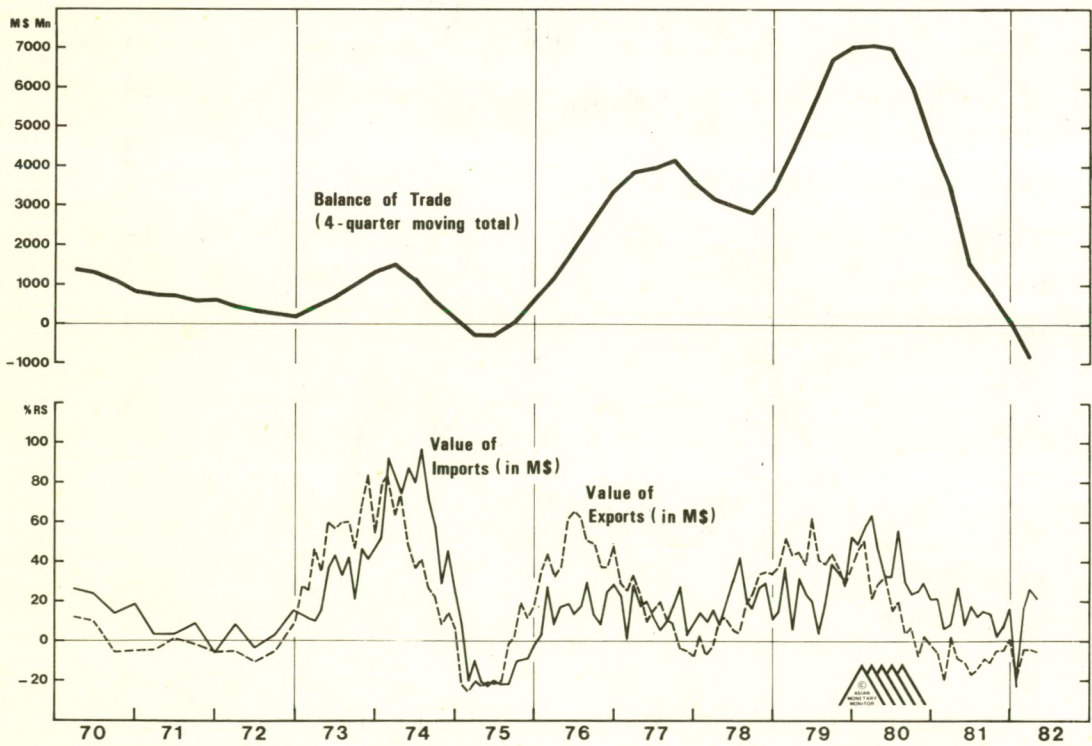


MALAYSIA

CHART 2: THE MONETARY BASE



Malaysia Chart 3: The Trade Account



However, for a country whose exports consist of a small basket of commodities subject to large swings in price, the adjustment process under either policy is likely to have some undesirable consequences. Under a freely floating exchange rate regime the exchange rate itself will tend to be subject to large swings. In the instance of declining commodity prices it will have to fall enough to maintain external equilibrium by supporting the domestic currency value of exports while reducing demand for imports. As export revenues in domestic currency terms will remain largely unchanged the profitability of, say, Malaysian mining or plantation companies and domestic purchasing power need not alter significantly.

In the case of the fixed rate regime, which is usually more appropriate for smaller economies, the adjustment process will be more painful. This is because the burden of balance of payments adjustment has to fall entirely upon import demand as export revenues are fixed in domestic currency terms. If commodity prices fall then export revenues will fall and the balance of payments will move into deficit. This will lead to a contraction in the monetary base, and monetary growth will have to contract to reduce import payments enough to bring the external balance back to equilibrium. In the longer run the profitability of mining or plantation companies will be maintained by a decline in their costs of production in the deflationary environment.

This case is best illustrated by the example of Chile, an economy based largely on copper and other base metals whose authorities until recently had adhered rigidly to the pegged rate principle, fixing the peso to the U.S. dollar and allowing no budget deficits or domestic monetary expansion. The result has been that in the first nine months of 1982 the monetary base contracted by 22% and the Chilean economy faces a 13% contraction in gross domestic product for the year, after an increase of 5.3% in 1981. Consequently, the authorities have had to abandon the rigid principle and allow the peso to float as well as allow some domestic monetary expansion.

This brings them more to the middle course taken by Malaysia, which operates a managed float of the exchange rate and since 1976 has tended to offset the balance of payments component of monetary growth by influencing the domestic component. This is clearly seen from Chart 2. This approach is probably more appropriate for a commodity producer facing large swings in prices, but as no real adjustment ever takes place it makes the economy susceptible to any secular decline in prices, caused by say, a structural shift in demand. In this cycle, as commodity prices have declined, the Bank Negara Malaysia (BNM) has allowed the Ringgit to depreciate against the U.S. dollar but not by enough to maintain the Ringgit value of exports. Consequently, the balance of payments has been in deficit and the BNM has partially offset the contractionary impact upon the monetary base by increasing the domestic component of monetary growth. Thus real growth has fallen fairly sharply but still remains high on a world comparison, and inflation has fallen but by no more than the world average.

So import demand has remained relatively firm and commodity-producers have been squeezed as costs of production have continued to rise while revenues have fallen.

Such a monetary policy works in the short term to maintain economic growth while the balance of payments deteriorates until commodity prices rise again. However, in the case of a secular decline in the prices of commodities, the economic adjustment process may be postponed and ultimately more damaging.

In Malaysia's case the balance of payments deficit has in fact been prevented from becoming too large by the scale of overseas borrowings undertaken to finance the budget deficit. A previous AMM article on Malaysia (AMM Vol. 6 No. 1) highlighted the problems the government might face financing a deficit of the size envisaged in a period when commodity prices were declining sharply. Despite the mid-year cutbacks in development expenditure the estimated deficit for the year of M\$10.2 bn. remains the same as that originally anticipated, due to the shortfall in revenues. The financing has ultimately been made possible by a sharp increase in Malaysia's overseas borrowings. Net foreign borrowings this year are expected to total M\$4.05 bn. or US\$1.72 bn., a total which has included a record US\$1.1 bn. syndicated loan completed in April.

Nevertheless, despite the capital inflows arising out of foreign borrowings the overall balance is still in deficit for the year. Chart 2 illustrates the extent to which BNM has run down foreign reserves to support the currency while maintaining monetary growth through domestic monetary expansion - effectively a reflection of partial monetization of the budget deficit. The increase of M\$2 bn. in net long-term capital inflows over last year, attributable to the foreign borrowing, has been offset by a sharp deterioration in the current account. Originally, last year's budget was based on an assumption of a current account deficit for this year of M\$6.48 bn. As suggested this estimate has turned out to be much too optimistic with the deficit for this year now expected to reach M\$8.65 bn. This can be attributed largely to the deterioration in the trade balance which has moved from a small deficit of M\$110 million in 1981 to a deficit of M\$2.5 bn. in 1982. This has been brought about by a small decline in exports while imports have grown by 6.9%.

The BNM may have done better to have allowed a steeper depreciation of the Ringgit. Given the strength of the U.S. dollar the policy of limiting the Ringgit's depreciation against the U.S. dollar has meant that the Malaysian currency has recorded substantial gains against some currencies, most notably the yen against which it has appreciated by 19% since the beginning of the year. This may have had the effect of encouraging too high a level of import growth. Also, a steeper depreciation, in helping to sustain export revenues would have had the effect of helping to sustain government revenues and preventing the need for such a build-up in overseas debt.

The new budget projects the trade deficit returning to a small surplus in 1983. The basis for this projection is imports remaining stable while exports register a growth of nearly 10%. It is true that despite the effect of the strength of the exchange rate, the lagged impact of the sharp slowdown in activity in the Malaysian economy may be enough to prevent a further growth in imports, and exports are expected to benefit by up to M\$1 billion from the coming on stream of 1.47 million tonnes of liquefied natural gas. However, even accounting for these factors, 10% growth in exports does seem a little optimistic.

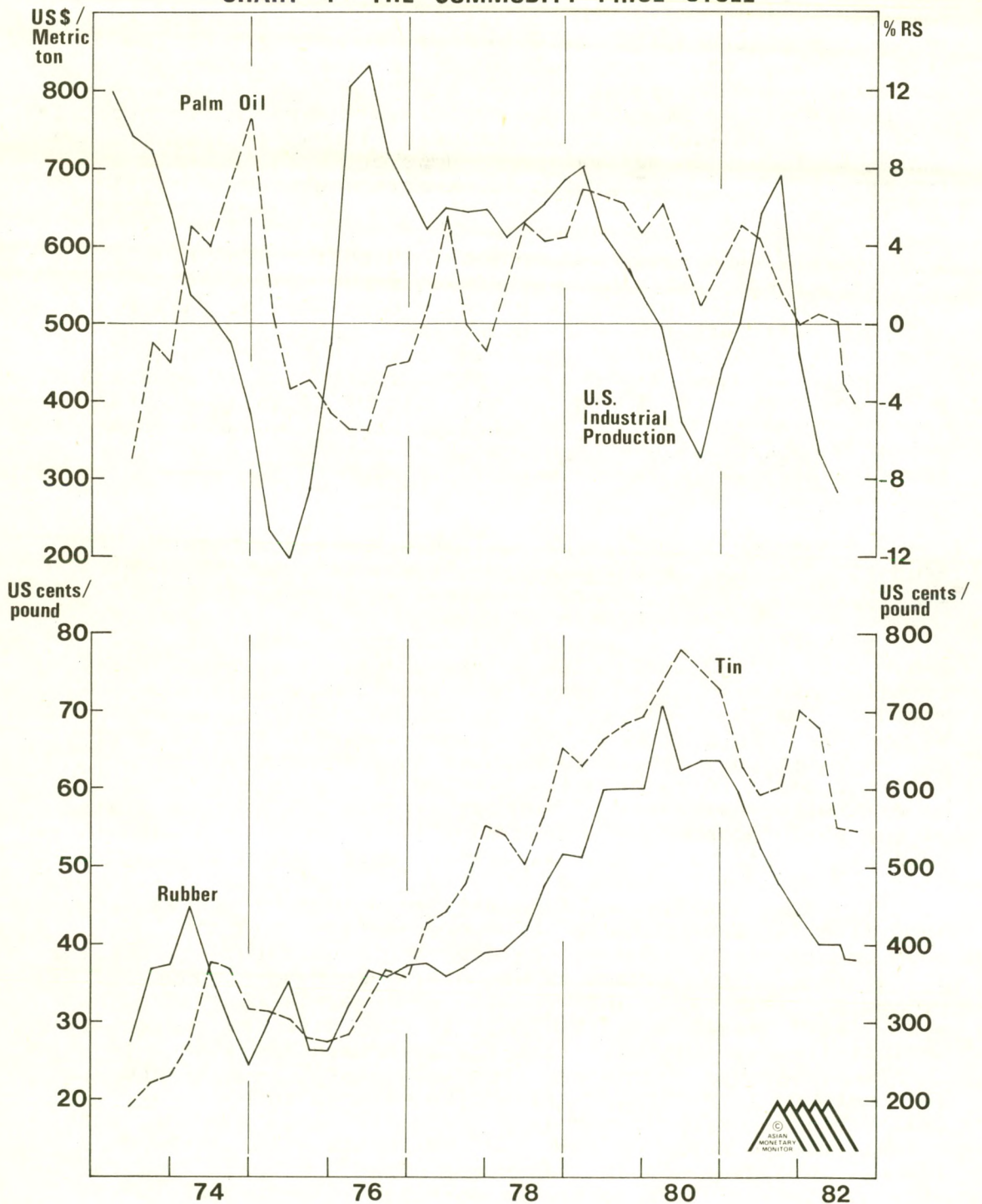
The key underlying assumptions behind the 1983 budget are real growth in the OECD economies reaching $2\frac{1}{2}\%$ in 1983, with an associated pickup in prices and volumes of Malaysia's soft commodity exports. The Malaysian economy itself is expected to grow at 4.9% next year, after a projected growth of 3.9% this year. The average price for rubber is expected to increase by over 7% and for palm oil by 6% while the tin price is expected to fall marginally. Export volumes for rubber and palm oil are expected to rise by 2% and 15% respectively, while the volume of tin exports is expected to fall by 14%.

In considering these projections, the $2\frac{1}{2}\%$ growth in OECD economies may not be unrealistic, if the U.S. economy begins to recover early next year. However, it is questionable whether even an OECD growth of this magnitude will translate into the pickup in the prices and volumes of commodities projected. In an admittedly fairly simplistic view Chart 4 reveals that Malaysian commodity prices tend to lag the world economic cycle, with the palm oil price lagging by up to as much as five quarters. This alone suggests that even if the world economy starts to recover now, commodity prices will not begin to react until at least the middle of 1983. Given the current state of commodity-producers and the state of the world economy, it seems hopeful to expect a pickup in both prices and volumes of Malaysia's soft commodities.

It seems likely that 1983 may prove to be a repeat of 1982 with revenues falling below expectations and the government being forced to scale back expenditures again later in the year by postponing or cancelling some development projects. This may enable them to achieve, as they have this year, their target deficit of M\$8.48 bn. With the reduced deficit it seems unlikely that the government will seek to increase overseas borrowings from last year's levels, and in a harsher international financial climate to do so at reasonable terms could anyway prove difficult. However, with a debt service ratio of only 4.9%, Malaysia still ranks as a low risk borrower and in that sense could even gain from the difficulties of other sovereign borrowers. Nevertheless, a continuation of the rapid build-up in overseas debt could worry creditors, and government projections for net long term capital inflows in 1983 anyway imply a similar or slightly lower level of overseas borrowings next year.

MALAYSIA

CHART 4: THE COMMODITY PRICE CYCLE

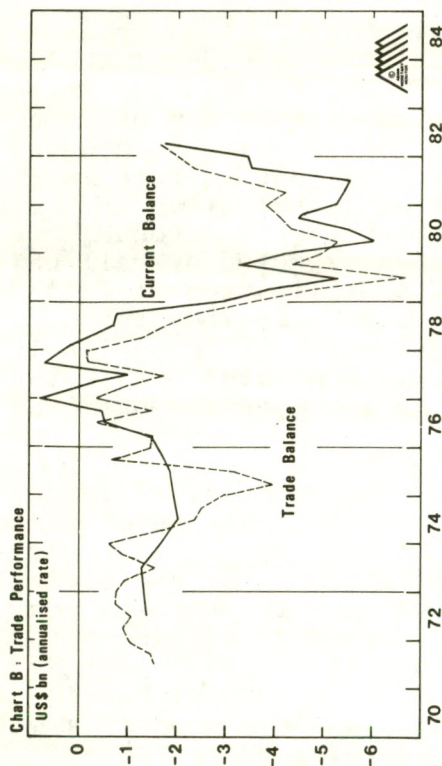
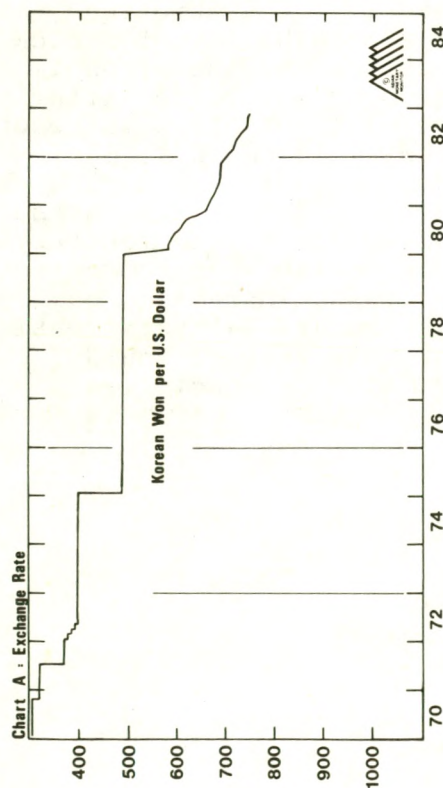


With a lower deficit and a similar level of overseas borrowing, government domestic borrowing should be slightly lower in 1983. Thus the financing of the budget deficit should not present too much of a problem. What may prove a problem is the Ministry of Finance's balance of payments forecast. If commodity prices and volumes behave more as in the normal cycle than the government anticipate then this may knock up to M\$1 bn. off the government's export revenue projections, resulting in a larger than expected overall balance of payments deficit for the year. The implication of this is that, if the Central Bank continues to stabilise the exchange rate at close to the current level, as seems likely, then its foreign exchange holdings will continue to fall thus putting continued downward pressure on the monetary base and on the money growth rate.

Since falling from above 30% at the beginning of 1980 to around 16% in the middle of 1981, monetary growth as measured by M3 has remained roughly stable. M1 has behaved in a similar fashion having decelerated sharply to August 1981 and having remained roughly stable since then (in June the year-to-year growth of M1 was 9.6% - see Chart 1). This is in line with the stability in monetary base growth over the past year as illustrated on Chart 2. We would not expect any pickup in monetary growth in the near future and in fact monetary growth may decline slightly towards the middle of 1983 as the negative effect of the balance of payments deficit continues to impact upon the monetary base and money supply.

FORECAST: The Malaysian government has repeated the mistake made last year of being over-optimistic in the assumptions underlying the budget. There is little possibility of a pickup in monetary growth over the next few months and the probability that soft commodity prices will not recover until the latter half of 1983 suggests that the economy will not begin to recover until later next year. By then an upswing in the U.S. and other OECD economies should have translated into increased demand for Malaysian exports and an improvement in Malaysia's terms of trade, as well as the beginnings of a recovery in monetary growth. Nevertheless despite continued weakness in commodity prices in the interim period the Ringgit should remain roughly stable against the U.S. dollar, as Bank Negara Malaysia continues to support the currency, although over next year it could begin to depreciate against the other major currencies.

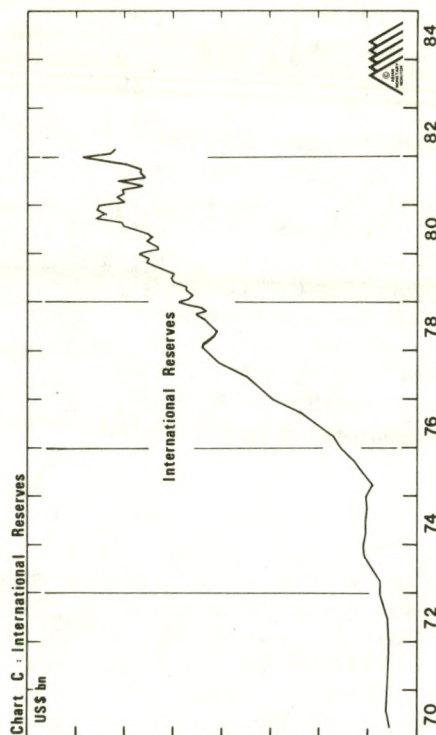
KOREAN WON



During 1982 the Korean Won has been 'managed' steadily downwards against the US\$, slipping from Won 695.7 in December 1981 to Won 745.0 in October 1982, which amounts to a depreciation of some 6.6%. The decision to allow the currency to slide downwards dates back to the devaluation of January 1980, but by mid-1981 it seemed as if the authorities had succeeded in controlling the money supply (Chart E), reducing the inflation rate, and stabilising the Won. In fact between May and October 1981 the Won traded in a very narrow range (683.8-686.6), and looked set to remain quite steady.

Since December 1981, however, the Korean authorities have leaned increasingly towards expansionism, jettisoning their monetary targets in June 1982 and allowing the Won to slide in a deliberate effort to stimulate the domestic economy and to promote exports. For the time being this strategy is paying off. Inflation is low thanks to the lagged effect of the downturn in industrial production in 1980 and the fact that the recovery in 1981-82 has been only mild so far. As a result, and particularly when combined with the currency depreciation, Korea has actually improved its competitive position quite significantly (Chart D).

The slack in the domestic economy and the improved competitiveness



have brought about a notable upturn in the trade and current accounts (Chart A), reducing the annualised current deficit from US\$5 billion per quarter in early 1981 to less than US\$1 billion in the second quarter of 1982. When the U.S. economy and other major economies recover in 1983 it is likely that this competitiveness even in the midst of global recession will make Korea's economy a major beneficiary of the global upturn. Initially, therefore, Korea is likely to benefit from a very strong trade and current account (comparable to the surpluses of 1977-78), and the current low level of inflation means that even a strong upturn could be sustained for several quarters without letting inflation get out of hand.

The big question the Korean authorities must face is this:

Should the nascent external surplus be allowed to translate into a surge of domestic liquidity growth through an increase in bank reserves, in bank lending and hence in the money supply? In order to prevent an external surplus generating explosive monetary growth along the lines of the 1977-78 monetary expansion (45% at the peak for M3, 51% for M1), the authorities must act now to stop the currency from depreciating, and must soon be willing to permit the Won to float upwards.

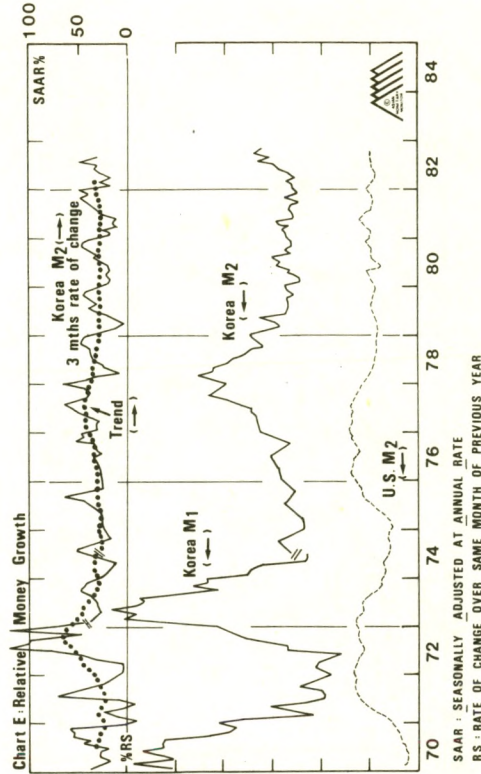
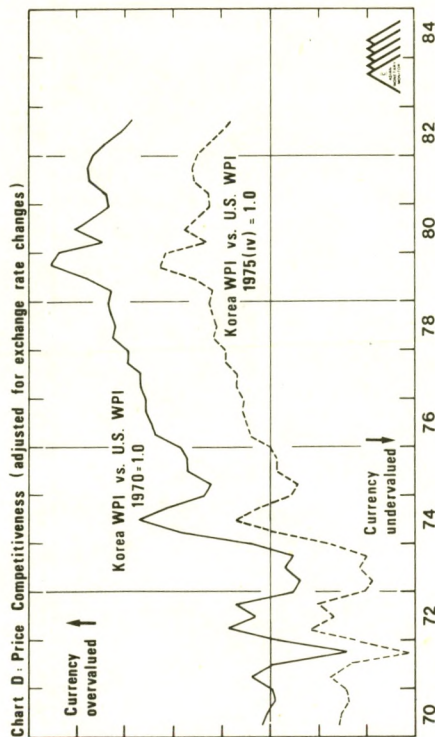
Despite the Korean authorities' temporary flirtation with monetary targets earlier this year and despite their new-found willingness to allow the exchange rate to move more frequently, one should be sceptical that they will adopt such a revolutionary policy. Indeed, monetary growth has already accelerated quite alarmingly in recent months with M1 hitting 38.3% in October and M2 touching 31.9% year-to-year. It would therefore be no surprise to see the exchange rate held down too long, the external surpluses build up, and the domestic economy overheating as the consequences of excess money growth take hold. Thus despite some dramatic improvements already evident in economic performance (better growth, improving trade accounts and lower inflation), the chances of any upward move in the Won must be considered minimal.

FORECAST

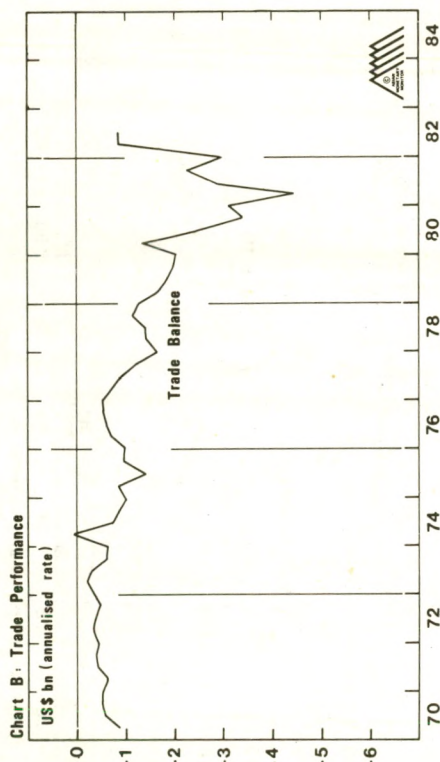
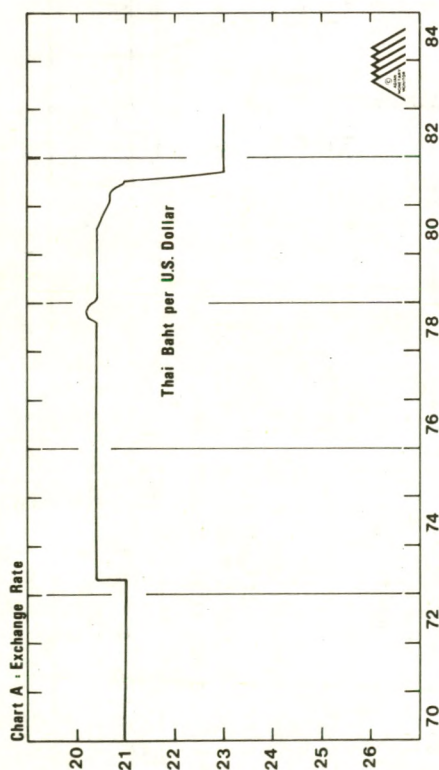
Won/US\$	1982	Q2	Q3	Nov-Dec	1983 Q1
FORECAST A				742-750	745-750
Actual Range	720.9-738.4		740.9-742.2		
FORECAST B				810	810

Forecast A The most likely exchange rate in the absence of some major political or external disruption.

Forecast B is based on simple projection of price competitiveness shown in Chart D i.e. the exchange rate required to bring U.S. and local price levels into line (using the 1975 base date).



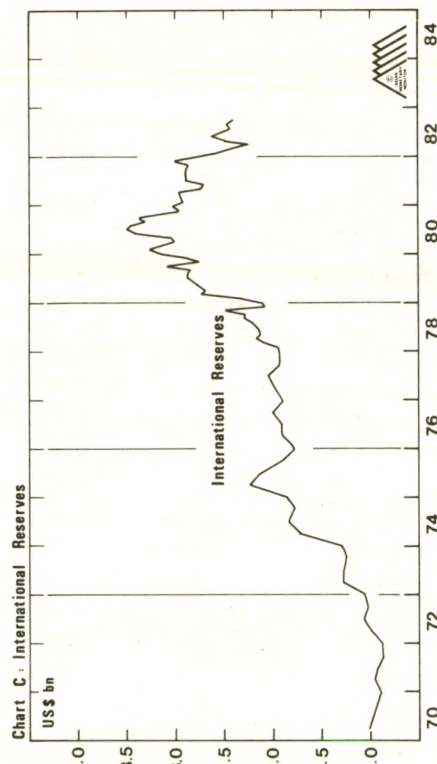
THAI BAHT



Since being devalued in July of 1981, the Thai Baht has maintained its parity of 23.0 Baht to the U.S. dollar, thus making it one of the strongest currencies in the world over the period. Underpinning this strength has been a fundamental improvement in the Thai economy which has made the economy appear one of the healthiest on the Pacific Rim.

The most significant change since the devaluation has been the improvement in the balance of payments. Despite sharp falls in the prices of rice, sugar and other soft commodities, Thailand has achieved a year-on-year rate of export growth of 15% due to a sharp pick-up in export volumes having been made possible by the bumper rice crop of 1981. Imports, on the other hand, have declined by 8%, a reflection of tight domestic liquidity, which persisted since early 1981 until the middle of this year. The result has been a marked improvement in the trade account where the deficit has more than halved since last year (Chart B).

Monetary growth has been fairly stable at low levels since the devaluation. In May of this year M2 was growing at a year-on-year rate of 18.1% while the narrower aggregate M1 was registering 4.9%



growth. Accompanying the fall in monetary growth since 1980 has been a fall in inflation which now appears to have stabilised at around 4.0%. The fall in inflation has meant that the Baht is now very close to its purchasing power parity level (Chart D).

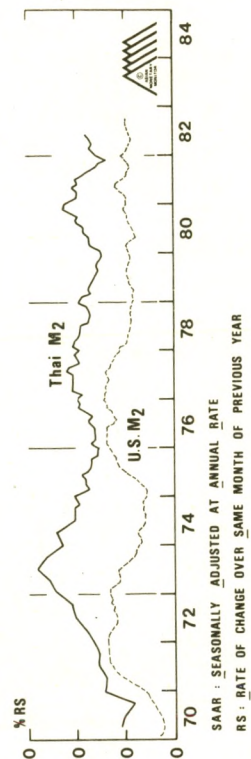
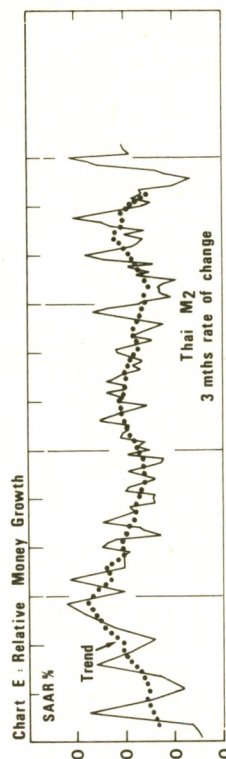
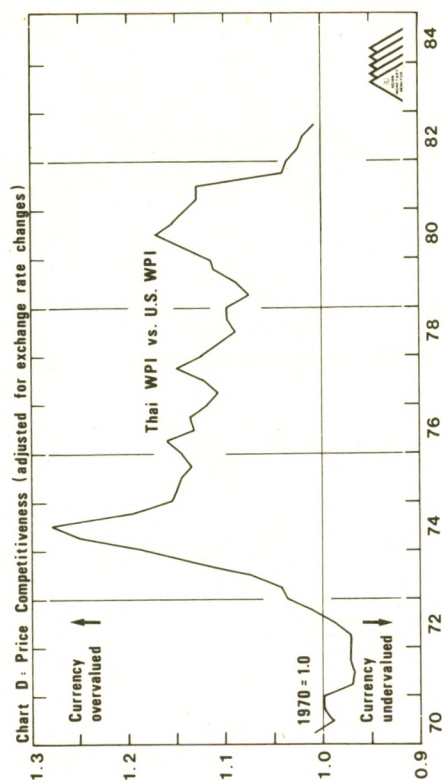
Monetary growth should begin to pick up from now as the improvement in the balance of payments continues to impact the monetary base. In May and June of this year the monetary base was growing at a year-on-year rate of over 8%, having previously recorded growth in the 5%-6% range over most of the post-devaluation period. This pick-up in monetary base growth will be sustained by the large capital inflows arising from private overseas borrowings in the wake of declines in overseas interest rates. These capital inflows will help support the balance of payments while export volumes begin to drop as a result of the poorer rice crop this year. Ultimately we may expect export values to begin a further improvement as the terms of trade start to improve, probably in the middle of 1983.

The continuation of the favourable trend in the balance of payments will support Thailand's foreign exchange reserves and prevent the need for any devaluation of the currency. Thus the Baht will remain at its current rate of exchange against the U.S. dollar into the foreseeable future.

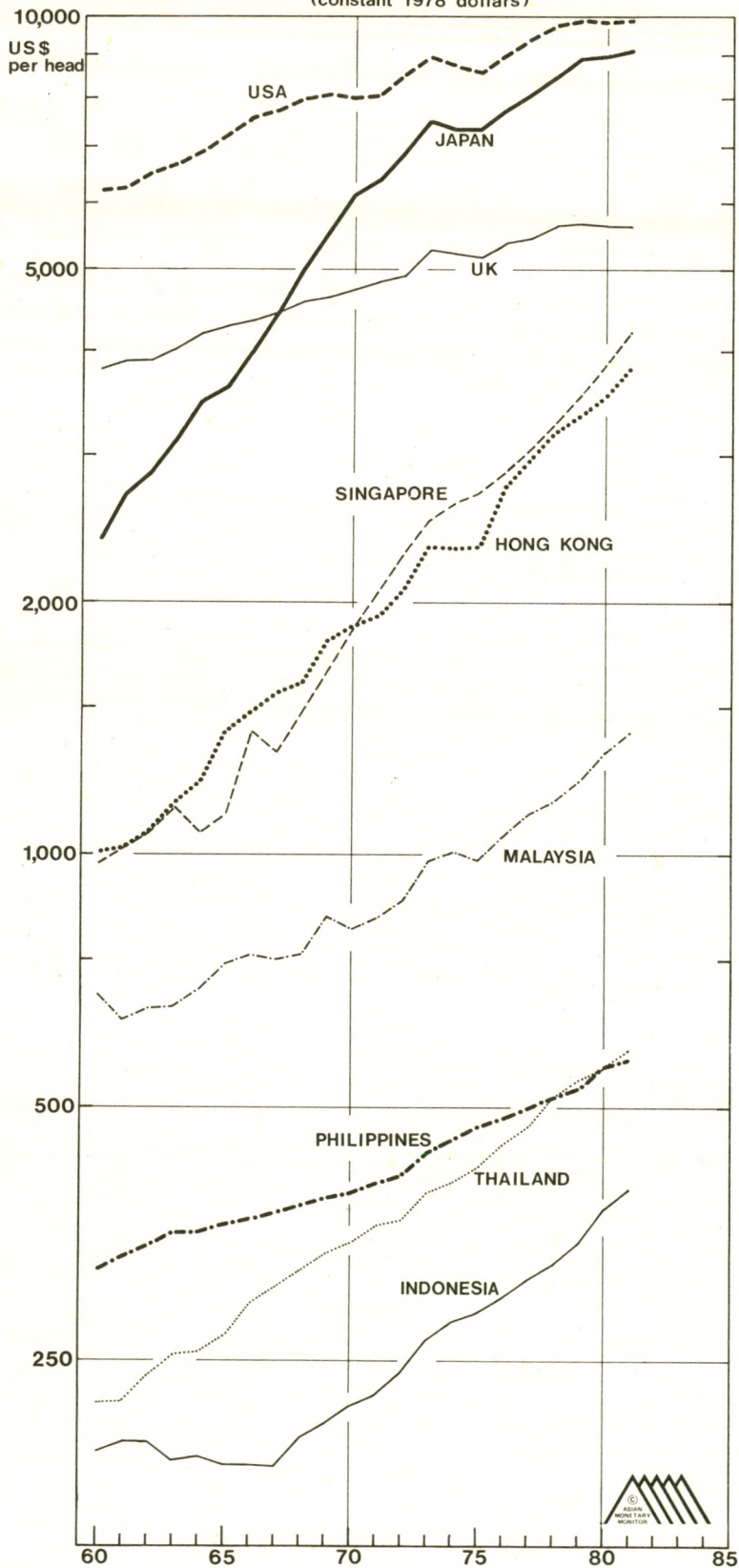
Baht/US\$	ACTUAL		FORECAST	
	1982 Q2	Q3	Nov.-Dec.	1983 Q1
FORECAST A			23.0	23.0
Actual Range	23.0	23.0		
FORECAST B			23.2	23.2

Forecast A The most likely exchange rate in the absence of some major political or external disruption.

Forecast B based on a simple projection of price competitiveness shown in Chart D i.e. the exchange rate required to bring U.S. and local price levels into line.

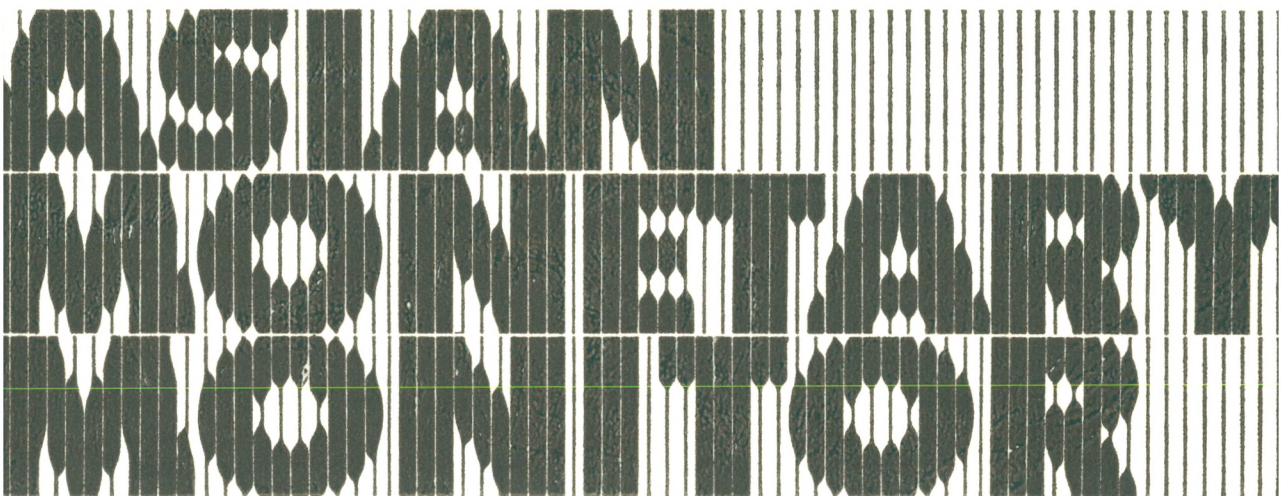


REAL PER CAPITA GDP IN ASIA
(constant 1978 dollars)





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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of
preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

HONG KONG'S FINANCIAL CRISIS

History, Analysis, Prescription

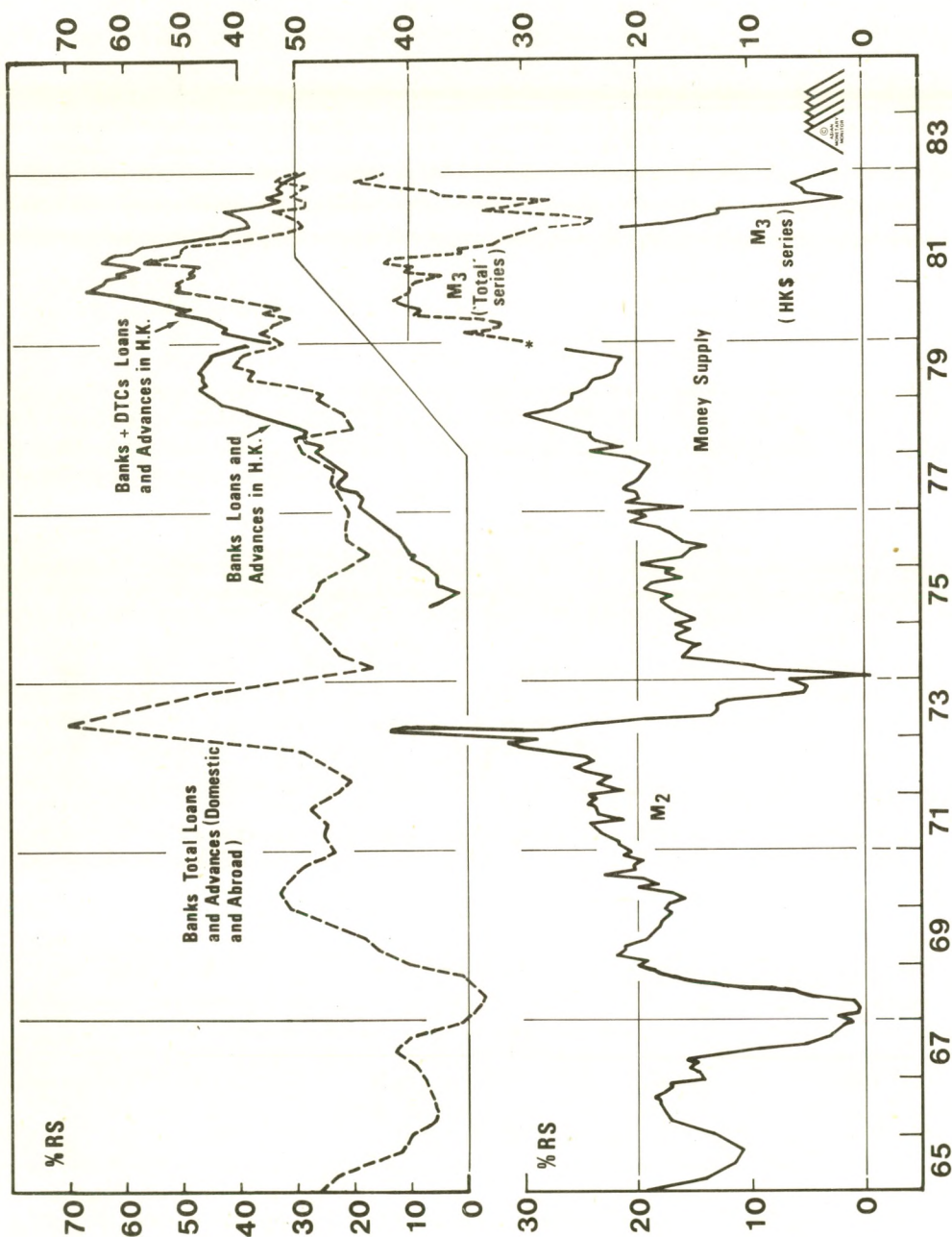
1. OUTLINE OF THE ARGUMENT

1. The Problem: In 1979-81 Hong Kong experienced excess credit creation which was the major source of the boom in the property market and the boom on the stock exchanges, but since 1981 this has been followed by a sharp contraction in the rate of growth of money and credit, leading to a fall in property values, a crash on the stock market, and serious liquidity problems for many of the quasi-banks which helped to finance the boom. To date no less than eight deposit-taking companies (DTCs) have been suspended or are in various stages of liquidation. It is this boom and bust cycle in money and credit which is at the root of the current financial crisis in Hong Kong - a crisis which would probably have occurred for economic reasons alone, even without the added uncertainty injected by the political negotiations in Peking over Hong Kong's future.
2. Current Stop-Gap Measures: The present approach by the banks and the authorities to the crisis is a form of fire-fighting rather than fire prevention. It is of course essential to put out the fires and ensure the surviving banks and deposit taking companies (DTCs) are both liquid and solvent, but is that enough? Without sensible, fundamental reforms can there be any assurance that the whole boom-bust cycle will not be repeated all over again in the future?
3. The Future: Given the present banking structure and assuming that no fundamental changes are implemented before the next economic expansion gets under way, it is almost certain that Hong Kong's whole boom-and-bust cycle will be repeated once again sometime in the late 1980s or early 1990s.
4. The New Banking Legislation of 1978-80: The series of revisions to the Banking and DTC Ordinances of 1978-80 did nothing to regulate the growth of money and credit on any sound basis. Far from making changes at a fundamental level, the new legislation simply imposed an artificial 3-tier compartmentalisation of financial institutions by size and maturity of deposit. This was itself discriminatory,

and, by its timetable of implementation, has accentuated the financial crisis among the DTCs. The new Ordinances also brought into being a statutory cartel - the Hong Kong Association of Banks (HKAB) - which enshrined interest rates as the key regulatory mechanism for controlling credit and money creation. But the experience of the past year or two and the wide fluctuations in money and credit growth have amply demonstrated the futility of that approach. In addition, at a time when the rest of the world was abandoning interest rates as an unreliable device for the control of money growth it is at the very least appropriate to question the wisdom of adopting interest rates as the primary instrument of monetary policy. It is hardly surprising that they should have turned out to be such a weak reed.

5. The Official Case underlying the need for a 3-tier banking system is tenuous. Moreover, the official case against the kind of thorough-going reform previously set out in AMM is either unpublished or unconvincing. (See box on pp. 58-59.)
6. The limited measures devised and implemented in 1979 and 1981 - namely the 100% liquid asset requirement placed on short term government deposits and the official scheme to borrow funds in money market in order to affect interest rates - have been entirely unsuccessful in moderating the wide fluctuations of money and credit growth. While they may have occasionally been used to some effect in raising the interbank rate by a fraction or temporarily defending some particular exchange rate, there is no evidence to suggest they have been anything other than useless in countering the broader problem of the huge amplitude of fluctuations in money and credit growth to which the Hong Kong economy has been subjected.
7. The Business Cycle can probably never be eliminated entirely - least of all in a highly open economy such as Hong Kong - but there is much to be said in favour of moderating the fluctuations of the business cycle by instituting monetary policies which do not actually promote instability (in the way that Hong Kong's peculiar system has done). Hong Kong would be better off with a mechanism which tended to restrain the economic upswing and moderate the downswing. In the belief that now is the time to be making plans for the longer term stability of Hong Kong's economy, some proposals are again put forward here which would accomplish these ends.

HONG KONG
CHART 1: MONEY AND CREDIT GROWTH



*Change of M2 to M3 series

2. BACKGROUND TO HONG KONG'S PRESENT BANKING LEGISLATION

Thanks to the laudable reluctance of the Hong Kong government to intervene in the private sector major pieces of banking legislation and other financial arrangements have usually been introduced to Hong Kong only in the aftermath of some crisis.

- The 1964 Banking Ordinance was brought in as a direct response to the 1961 banking crisis.
- The interest rate agreement was introduced in 1966 in the aftermath of the 1965 Banking Crisis.
- The Office of Commissioner for Securities, the Securities Ordinance, and the Protection of Investors Ordinance were all introduced in 1974 in response to the stock market boom and crash of 1972-74.
- The DTC Ordinances from 1976 onwards were brought in to regulate a part of the financial sector which was growing at such a pace that it posed a direct threat to the Licensed Banks and their interest rate agreement.
- More recently a 3-tier banking system has been brought into being with the specific aim of protecting the Licensed Banks' "interest rate agreement" which was rapidly being eroded by the competitive, free market interest rates offered by the deposit-taking companies (DTC's) for deposits in excess of HK\$50,000 (about US\$7,500).

From an analytical standpoint, however, this type of "reactionary" legislation has inevitably produced a somewhat curious and makeshift banking structure. The peculiarities of the Hong Kong system have resulted in a system which, in our view, positively promotes monetary instability because the authorities are virtually powerless to affect the rate of monetary growth, while the banks are not restricted by any external constraint on the rate of credit and money creation and consequently they are free to alternate between phases of exuberant credit expansion and extreme cautiousness and timidity. This results in wide swings in money and credit growth. (The non-bank public is for the most part not responsible for these wide swings in money and credit growth, but from time to time there have been episodes involving large scale conversions of deposits into currency by the public - such as in 1965 and 1967 - precipitating a sudden monetary contraction.)

In more orthodox banking systems the role of the authorities is to limit money and credit growth in the expansion phase of the business cycle by restricting the availability of bank reserves, a process which is usually reflected in rising interest rates as a symptom of tight money, while in the contraction phase the role of the authorities is to ensure

that banks still have loanable funds by continuing to provide ample reserves, a process which is normally reflected in falling or low interest rates as a symptom of easy money.

The most recent monetary contraction (see Chart 1) has been followed by a collapse of property prices, a slump on the stock market, and a rash of bankruptcies in the property sector. Predictably, the cry is going up for more supervision, tighter control over bank lending to the property sector or to individual borrowers, tougher disclosure requirements, more vigorous scrutiny of the ownership of public companies, and more exacting standards for registration of DTCs.

But if our analysis is broadly correct the real problem which requires attention is the fundamental instability of the monetary system as a whole. For as long as money and credit growth alternates between phases of dangerously rapid expansion and phases of abrupt curtailment or contraction, bankers and businessmen will inevitably make greater mistakes and get caught in a more severe financial squeeze than they would otherwise have done under a system which promised more stable money and credit conditions throughout the cycle. Responding to the present crisis by instituting tougher, more extensive supervision only treats the symptoms of the credit crisis, it does not treat the underlying causes.

Prudential arrangements and supervision are one problem; monetary stability is another problem. More detailed supervision will not control fluctuations in money and credit, but controlling money will limit potential disturbances in the system, and in so doing avoid the need for the extensive, interventionist type of supervision which Hong Kong is gradually drifting towards in the wake of each financial crisis.

It is true that there have been abuses associated with the recent boom-and-bust cycle, but reforms aimed only at increasing supervision without improving the underlying processes which determine the growth of money and credit do not tackle the root cause of monetary instability, namely the ability of banks and DTC's in Hong Kong to create (or not to create) credit more or less at their own discretion. Before 1972 banks in Hong Kong did not have such discretion, and consequently the ups and downs of the normal business cycle were not so severe.

The origins of Hong Kong's monetary instability since 1972 are to be found in (1) the technical innovations affecting the operation of the Exchange Fund in 1972-74 and (2) the failure of the subsequent misdirected banking legislation to counteract those measures.

(1) The 1972-74 changes in Hong Kong's financial system removed the external constraints on excess money and credit growth but failed to substitute any internal discipline in the form of any domestic means of restraint or control. It is most important to understand this proposition because all too often the mere suggestion that Hong Kong should introduce any method of controlling money and credit is dismissed as outright

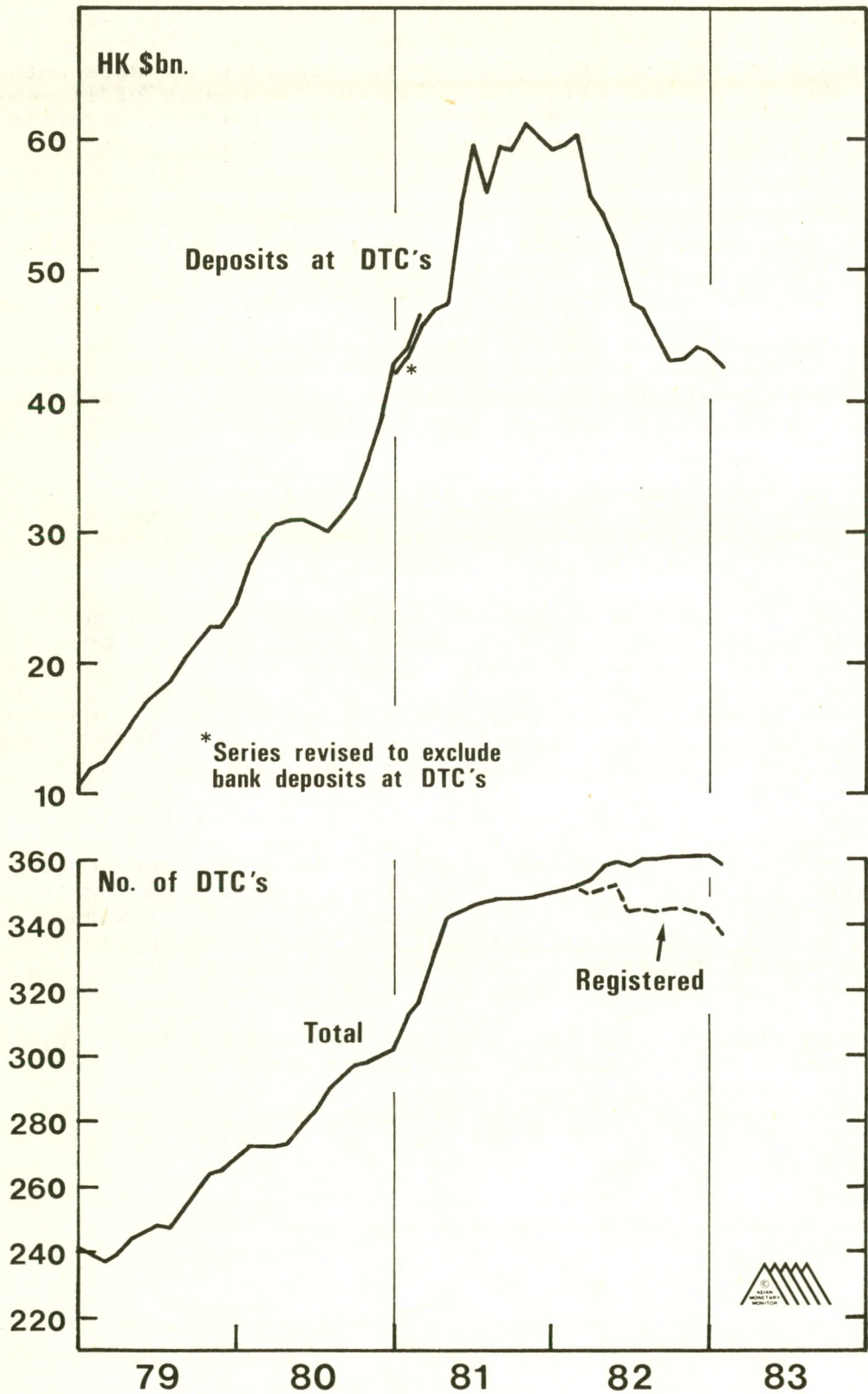
interventionism or a failure to appreciate the benefits of Hong Kong's free market, laissez-faire philosophy. Yet the fact is that in all the years up to 1972 there was a very real control on the rate of monetary growth in Hong Kong. (The pre-1972 mechanism is explained on pp. 42-49). The fact that this mechanism of control was not an overt, explicit one does not mean that it was not effective. Indeed, the beauty of it was that it was automatic and unseen (even if not widely understood). Basically the authorities did three things in 1972-74 to undermine the operation of the old automatic monetary control system:

- i) they changed the note issue mechanism in 1972 by allowing the note issuing banks to issue HK\$ notes in exchange for local currency rather than foreign currency;
- ii) they set up or greatly expanded the use of Exchange Fund deposit accounts in HK\$ with the commercial banks, thus making the Exchange Fund a client of the banking system rather than the sole source of bank reserves; and
- iii) the Hong Kong dollar was allowed to float free in November 1974, thus ending any formal link between the price level or inflation rate in Hong Kong and the price level or inflation rate overseas.

(2) The new banking and DTC legislation has been based largely on the premise that the money supply and bank credit expansion can be satisfactorily influenced (if not successfully controlled) by means of regulating interest rates through the licensed banks' interest rate agreement. The legislation has not been aimed at rectifying the measures taken in 1972-74 and has instead attempted to impose some degree of order on the banking system by (a) compartmentalising it into three sectors and (b) formalising the mechanism through which deposit interest rates are set by the licensed banks. However both of these measures are much too nebulous to have any precise effect on money and credit growth. They also assume a much tighter link between any given level of deposit interest rates and money growth than actually exists, and they leave completely untouched the mechanism by which money (banknotes or deposit money) is created in the Hong Kong banking system.

Other sections of this analysis will explain first why Hong Kong's present monetary instruments don't work, second how the pre-1972 adjustment mechanism operated and how it was undermined, and finally we reiterate some proposals for reform first made in AMM three years ago and which we believe still hold valid today.

HONG KONG : CHART 2 THE RISE AND FALL OF THE DTC's



READING HONG KONG'S MONETARY STATISTICS

Economists study the money supply in order to try to predict changes in the money and securities markets, in the level of business activity, and in the rate of inflation. There is no pre-ordained definition of the money supply which is guaranteed to give the best answers (or predictions), and consequently there is a need for continuous empirical testing and evaluation of the various definitions. However, insofar as one is attempting to predict the overall rate of growth of expenditures in nominal terms for the domestic economy (i.e. nominal GDP), it is desirable to collect statistics of the domestic currency and deposit holdings of local residents. By implication one is not interested in the local currency and deposit holdings of non-residents, nor in the foreign currency holdings of residents.

In theory it might seem that transactions balances (i.e. demand deposits and cash currency) should be more significant than other types of money, but this is not necessarily so. To answer this categorically one has to have information about the habits of payment in the community, and the ease of shifting money holdings from one type to another. It is therefore by no means true that M1 is a better predictor of GDP or GNP or GNE than other measures. In the countries of East Asia we have in fact generally found a better relationship between broader measures of money (M2, M3 etc.) and total nominal expenditures than between narrow measures and GNP.

In Hong Kong before December 1979 M2 measured the cash currency held by the public, plus all non-bank deposits (local currency denominated and foreign currency denominated) at the licensed banks. Because interest rates on these deposits were held down below free market rates by the "interest rate agreement", many firms and individuals started placing their deposits with so-called deposit-taking companies, i.e. quasi-banks which were outside the scope of the interest rate agreement and could take deposits in excess of HK\$50,000 (about US\$10,000 at the time). These deposits at DTCs were not included in M2, so that as DTC deposits swelled, the reported M2 statistics began to slow down. Another problem was that deposits by DTCs with the licensed banks were still included in the reported deposits of the licensed banks i.e. what were effectively interbank deposits were mixed up with deposits of the non-bank public. Finally, the inclusion of foreign currency deposits meant that the reported statistics were not a pure measure of HK\$-denominated purchasing power.

To clear up these problems the presentation of the statistics was completely revamped following the implementation of the Monetary Statistics Ordinance in January 1980. The new data report on three HK\$-denominated money supply totals, HK\$M1, HK\$M2 and HK\$M3 (and their components) together with three corresponding figures which include non-HK\$ denominated items named Total M1, Total M2 and Total M3. (See AMM Sept.-Oct. 1981.)

In relating the behaviour of the domestic Hong Kong economy to the monetary aggregates it is almost certainly the HK\$-denominated series which is likely to be important. After all, including the foreign currency denominated deposits in Hong Kong's money supply is akin to including in the British Sterling M3 statistic all the London-based Euro-currency deposits, which is clearly likely to be misleading for the purpose of

predicting the behaviour of the domestic UK economy.

As the charts opposite show, over the past year the behaviour of the 'total' money series has been quite different to the behaviour of the HK\$-denominated series, largely due to (1) the removal of the 15% withholding tax on interest on foreign currency deposits in Hong Kong and (2) due to the reduction of interest withholding tax on interest on HK\$ deposits from 15% to 10%.

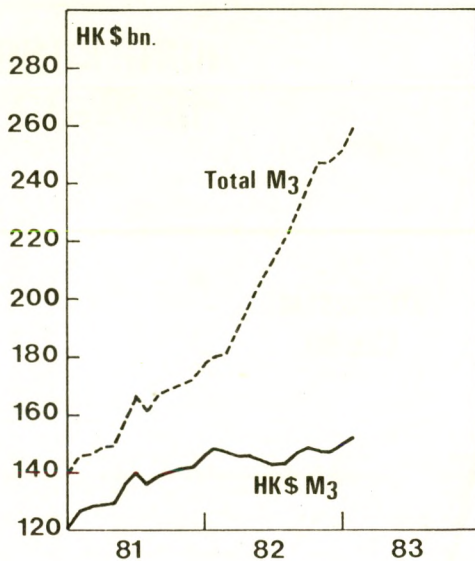
The removal of the 15% withholding tax on foreign currency deposits has encouraged those who previously held such deposits in Guam or Port Vila or elsewhere to deposit those funds with banks or DTCs in Hong Kong. The booking of these deposits in Hong Kong has virtually no monetary significance for Hong Kong, though it may help Hong Kong to boost its claims as a financial centre. But it's clear that attempting to use the Total M3 series as an indicator for predicting the course of the Hong Kong economy is likely to be seriously misleading.

Leaving the withholding tax on HK\$ interest at 10% has led to the "swap deposit" phenomenon. Holders of HK\$ deposits who wish to avoid the 10% withholding tax make an agreement with their banks to book the HK\$ deposit in (say) US\$, and simultaneously agree on a rate at which the US\$ will be "converted" back to HK\$ at the end of a fixed period, say three months. This rate will be such as to compensate for any difference in HK\$ and US\$ interest rates over the period concerned, and takes account of the cost of holding funds over that period. If this transaction goes through the market so that HK\$ are sold for US\$ on the spot market against an exactly matching transaction in the forward market, there will be no effects on or distortions to the statistics because another party buys the HK\$ which are then redeposited in the system. But if the transaction is in the form of a repurchase agreement conducted only by reference to market rates, then there could be some distortion to the statistics because what the customer holds is actually a HK\$ deposit, but what the banks report is a US\$ deposit.

The swap deposit phenomenon could account for some of the discrepancy between the growth rate of total M3 and HK\$M3, but most of the discrepancy is surely due to the shifting of foreign currency deposits from other offshore centres to Hong Kong as a result of the abolition of withholding tax on foreign currency interest payments.

READING HONG KONG'S MONETARY STATISTICS.

Absolute Levels



Year-to-year % changes

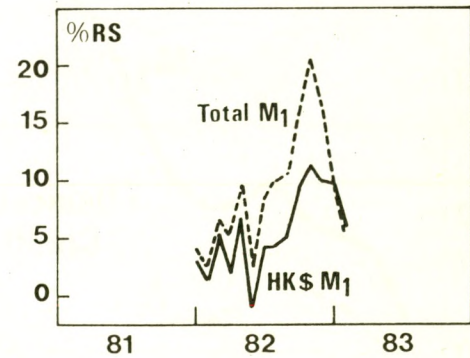
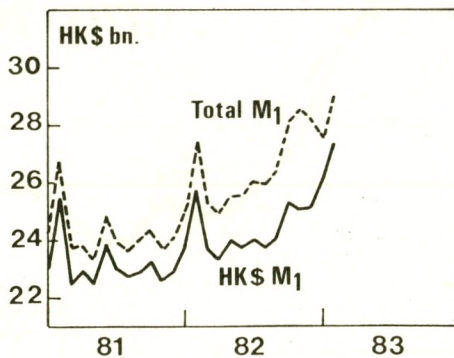
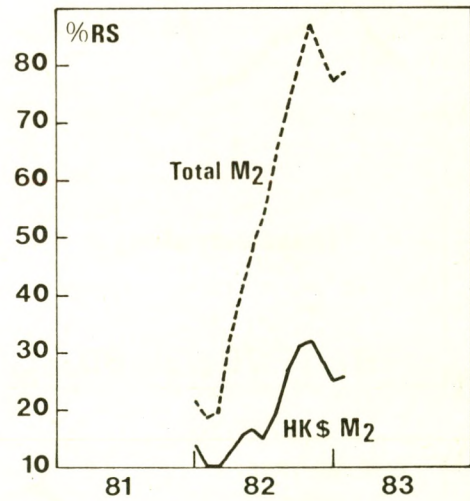
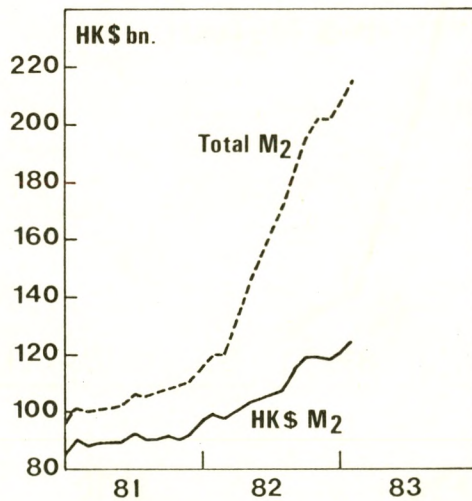
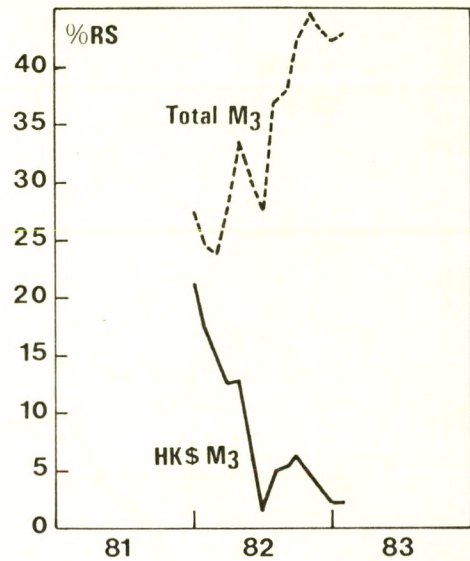
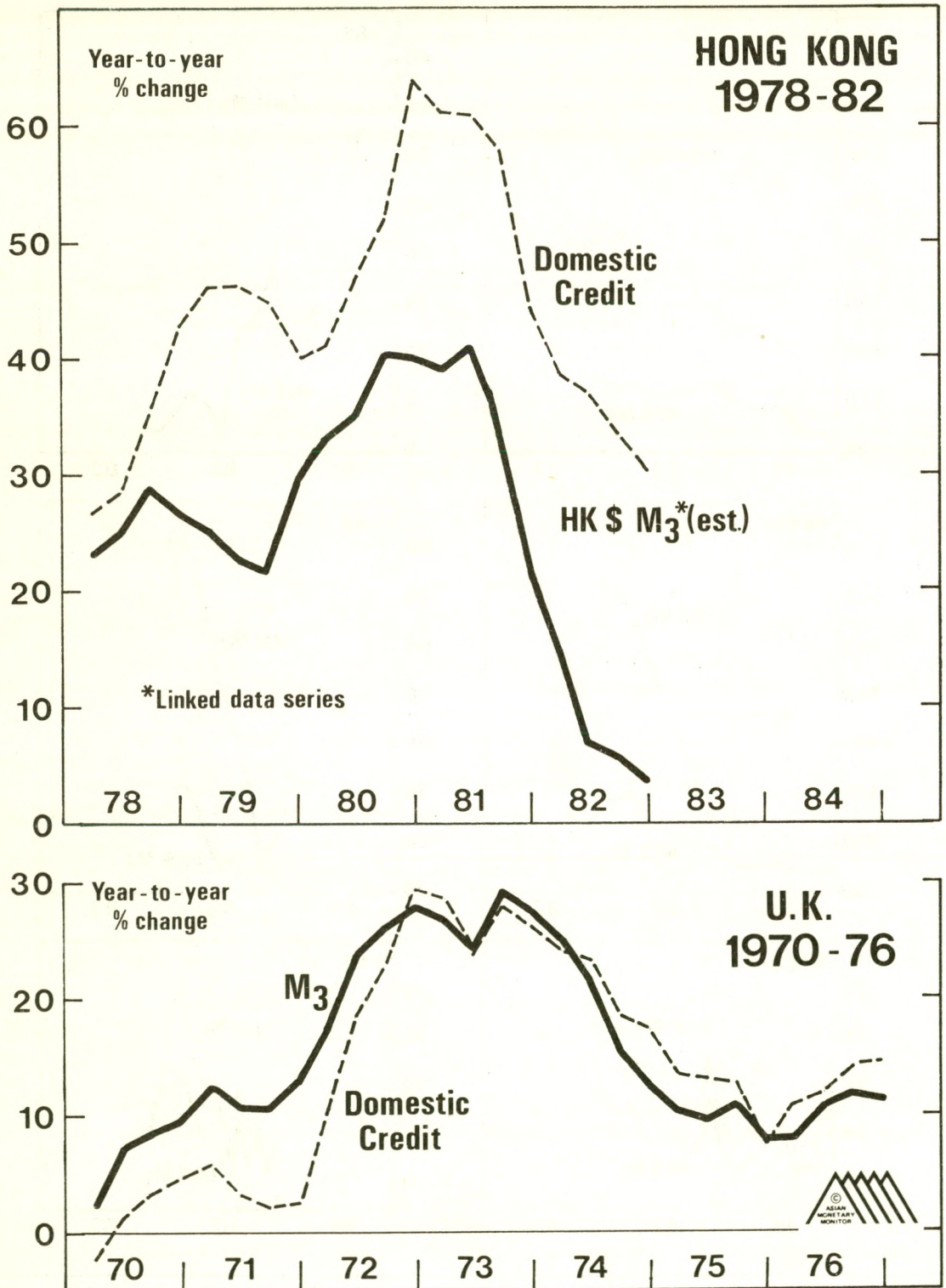


CHART 3

THE U.K. SECONDARY BANKING CRISIS AND HONG KONG'S DTC CRISIS : A STRIKING PARALLEL



THE BRITISH SECONDARY BANKING CRISIS OF 1973-74 AND THE HONG KONG DTC CRISIS OF 1982-83 : SOME STRIKING PARALLELS

1. With the accession of Edward Heath's conservative government in June 1970 and following the publication of "Competition and Credit Control" in 1971 by the Bank of England loan ceilings on the larger banks and finance houses were scrapped, money and credit growth exploded, a variety of quasi-banks authorised under section 123 of the 1967 Companies Act flourished, and the property market took off. In Hong Kong finance companies which had grown up outside the licensed banks' interest rate agreement started to be regulated by the Deposit-Taking Companies Ordinance of April 1976, though no effective restrictions were placed on their growth, so that by April 1981 (when registrations were suspended) there were no less than 350 registered DTCs. Meanwhile money and credit growth had soared, and the property market was booming. By the end of 1981 DTCs had captured one third of the deposit market.
2. As a part of the financial U-turn away from the "Dash for Growth" the Heath government imposed a general prices and incomes standstill in Britain in November 1972, to include all commercial rents. With the economy showing signs of overheating in many sectors, the pound under pressure and the balance of payments deteriorating MLR was finally raised from 7.5% to 9% on July 20th 1973 and then to 11.5% on July 27th. Banks' base lending rates rose to 11%. By September 1973 the Bank of England was requesting the banks to exercise "restraint on lending for property development and financial transactions". These belated attempts to curb the boom sowed the seeds of the 1973-74 secondary banking crisis.

In exactly the same kind of build-up to the DTC crisis of 1982 the Hong Kong authorities first extended rent controls to all residential accommodation in December 1980. In May 1981 the Financial Secretary introduced legislation to restrain the growth of DTCs, and explained the necessity for a 3-tier banking system. As the economy became more overheated and inflation took hold the Hong Kong dollar plunged in September 1981, until finally in September and October 1981 interest rates were sharply raised taking prime to 20%, well above prevailing interbank rates. These belated initiatives during 1981 caused the property market to turn and set the scene for the DTC crisis of 1982-83.

3. Perhaps the most striking parallels in the British and Hong Kong cases are the extraordinary similarities in the growth profiles of money and credit over the whole period in both countries, and the authorities' attitude towards the use of interest rates in both places. The similarity in the growth profiles of money and credit is abundantly clear from the charts opposite. Also, in both places the authorities failed to raise interest rates sufficiently in the early stages of the credit expansion to choke off the demand for loans, and consequently the money supply ballooned. Subsequently both governments had to see to it that rates were raised sharply and far enough to choke off credit demand. The result in both cases was a painful and far-reaching downturn.

These experiences suggest it would have been far better in each case to have restrained money and credit growth earlier during the upswing by some reliable mechanism (not necessarily interest rates), and then such a drastic downswing would probably not have been precipitated, and the associated financial crisis in each case would have been greatly alleviated.

3. HONG KONG'S MONETARY INSTRUMENTS AND WHY THEY DON'T WORK

A. Liquid Assets - Their Shortcomings as an Instrument of Monetary Control

Liquid assets were intended as a prudential device but in Hong Kong they have come to be used as a monetary instrument. As a prudential device liquid assets are inferior to other methods of protecting depositors; as a tool for regulating monetary growth they do not work.

Liquidity ratios were first introduced to the British banking scene in 1955 when the clearing banks were required to observe a 30 per cent minimum ratio of liquid assets to deposits. In 1964 the ratio was reduced to 28 per cent. From 1946 to 1971 there was also a narrower cash ratio of 8 per cent applicable to London clearing banks. In 1971 both ratios were replaced with a so-called reserve asset ratio of 12½% of eligible liabilities, though this excluded assets which were also liabilities of the Bank of England such as vault cash.

The importance of these British practices for Hong Kong was that in the period following the run on the Liu Chong Hing Bank in 1961, recommendations were made for Hong Kong by Mr. H.T. Tomkins of the Bank of England which relied heavily on British practice, and in particular on the intellectual framework adopted by the Report of the Radcliffe Committee on the Working of the (British) Monetary System (1959). These recommendations were enshrined in the Banking Ordinance of 1964 which under Section 18 imposed on Hong Kong's licensed banks the obligation to hold certain specified liquid assets equal to at least 25% of their Hong Kong dollar deposits. The 25% ratio was divided into two categories, 15% was required to be held in certain "super-liquid" assets and the remaining 10% could be held in assets deemed to be slightly less marketable. Over the years there have been some changes in the definition of liquid assets, but they have remained unaltered in principle.

As a prudential device to protect depositors the ratios were dramatically put to the test by the banking crisis of 1965, the year following their introduction. Evidently they did not stop bank runs, and their definition was therefore tightened up so as to permit only net balances with other banks in Hong Kong to qualify as a part of the extensive amendments to the Banking Ordinance in 1967.

The problem with liquid asset ratios as a prudential device is that while they may ensure that at least a proportion of bank deposits is matched by readily marketable assets, they cannot protect depositors to any greater extent than the liquid assets themselves if other bank assets or bank capital are not available due to illiquidity or insolvency. In this respect they are inherently inferior to deposit insurance as a means of protecting depositors.

The problem with liquid assets as a device for monetary control is that usually those assets defined as liquid assets do not correspond to the liabilities of the monetary authority, and therefore the monetary consequences of changes in the supply of liquid assets are not predictable. Moreover, since both the government and the private sector can issue liquid assets, the monetary authorities cannot control the amount that may be available to the banks to acquire.

In Hong Kong the authorities generally used to acknowledge that the liquidity ratios were a prudential device rather than a device for monetary control, yet in 1979 the regulations were altered for specifically monetary control purposes. The banks were required to maintain 100% liquid asset cover against any deposits of the Exchange Fund designated as short-term deposits. The authorities' belief was that by requiring banks to hold liquid assets corresponding to such short-term deposits they would sterilise the inflationary note issue mechanism that had been introduced in 1972. However, money is a uniquely fungible commodity, and there can be absolutely no assurance that any particular asset on a bank's balance sheet corresponds to any particular deposit liability, so provided that banks can obtain or create liquid assets without any difficulty (as any Hong Kong banker will cheerfully attest) it is evident that there is a still major loophole in the system.

To put it another way, so long as the banks can manufacture liquid assets to match any local requirement, there is likely to be very little effective restraint from this source on their willingness to create credit. The fact that Hong Kong's licensed banks have persistently been able to maintain average liquidity ratios of well over 45% as against a required ratio of 25% suggests that meeting the minimum requirement is not exactly arduous. To argue, as one official has, that a 50% liquidity ratio makes Hong Kong one of the most liquid financial centres in the world is plain silly; it could equally well be said that Hong Kong's liquidity ratios are among the easiest in the world to satisfy!

THE LIQUIDITY RATIO—A MISLEADING INDICATOR

2 DISTINCT MEANINGS OF LIQUIDITY

Much confusion in economic or financial affairs arises from a failure to define one's terms. A good example is the use of the word "liquidity". There are two quite distinct senses in which the word is popularly used, and it is vital to separate them. First there is liquidity as applied to an individual bank or other financial institution. Liquid in this sense means either that the bank or finance company has prudently matched the maturities of its assets and liabilities, or that a significant proportion of its assets are of very short maturity and hence easily realizable (i.e. marketable). Second, liquidity is sometimes used in reference to the financial system as a whole. Typically when interest rates are low people say that the financial system is highly "liquid". Conversely when interest rates are high fears are expressed that the system is "illiquid".

"Liquidity" under the Banking Ordinance

Under Section 18 of Hong Kong's Banking Ordinance the licensed banks are required to observe and maintain certain Specified Liquid Asset Ratios. These requirements were introduced in 1964 following a minor banking crisis, to ensure that individual banks were "liquid" in the first sense by requiring every bank to hold minimum ratios of certain kinds of assets to deposit liabilities. In effect the ratios provided a minimum prudential standard. In addition, Section 23 of the Banking Ordinance restricts loans to any single customer of a bank to 25% of the bank's paid-up capital and reserves, while Section 24 restricts unsecured loans to directors, their relatives or related companies. Finally the Ordinance places restrictions on shareholdings and loans for real estate not used for banking purposes. "Liquidity" in this prudential or balance sheet sense, however, has nothing to do with liquidity in the aggregate or macro-economic sense.

"Liquidity" and Inflation

Liquidity in a broader sense can refer to the quantity of money in relation to the volume of goods and services produced by the economy. In this sense "excess liquidity" occurs when the supply of money persistently grows more rapidly than the demand for it at any given overall price level. In the early stages the greater quantity of money available leads to lower interest rates. At the next stage business activity is stimulated as spending as spending increases. The ultimate result is a general rise in prices (as well as wages, rents, interest rates etc.). If the growth of the money supply now slows down this is typically accompanied by a further rise in interest rates and a "credit crunch" or "liquidity squeeze".

One way to avoid inflation, therefore, is for the monetary authorities to design a system which regulates or controls liquidity in the second sense i.e. the quantity of money relative to the quantity of goods and services produced in the economy. In order to avoid runs on banks, or to ensure prudent banking behaviour, or to protect depositors from loss, or to protect bankers from overextending themselves to individual borrowers it may or may not be regarded as desirable to specify a whole variety of ratios and restrictions along the lines of the Banking Ordinance. But even the most complex and far-reaching controls on liquidity in this balance sheet sense provide absolutely no guarantee that there will not be excess liquidity in an aggregate, macro-economic sense. Hong Kong's Liquidity Ratio is therefore potentially misleading because even if every single bank conforms minutely to the liquidity requirements, the stability of the financial system as a whole may nevertheless be threatened more by the general disturbances that accompany inflation resulting from excess liquidity in the second sense than by any individual instance of illiquidity in the first sense.

THE LACK OF GOVERNMENT DEBT - A RED HERRING*

It is sometimes stated by private bankers and by public officials that the lack of any government debt in Hong Kong hinders the establishment of a Central Bank. This argument is mistaken. There is no reason why a Monetary Authority or Central Bank needs to conduct its operations in government debt, nor any reason why the Monetary Authority should hold any government debt as a part of its assets.

Consider the situation in Japan from 1949 to 1973. Throughout most of that period the Japanese government maintained a budget surplus so there was virtually no government debt, and yet the Bank of Japan supplied reserves to the banks either by purchasing foreign exchange and selling yen to the City Banks, or by discounting private sector export bills or by making direct loans to the banks. The Bank of Japan held almost no government debt. Yet despite this, the Bank of Japan was able to influence monetary growth upwards or downwards, and Japan accordingly experienced distinct phases of monetary acceleration alternating with periods of monetary deceleration.

Consider the situation in Singapore today. The Government of Singapore issues substantial quantities of debt, but almost all of it is purchased by the Post Office Savings Bank and the Central Provident Fund; almost none is purchased by the Monetary Authority of Singapore (MAS). The assets of the MAS consist mainly of foreign exchange (92% as at the end of March 1978) and the MAS conducts its operations for the most part in the foreign exchange market. Government debt exists, but, except for small-scale operations in Treasury Bills, it is not central to the conduct of monetary policy.

It is true that Central Banks such as the U.S. Federal Reserve System or the Bank of England conduct their open market operations largely in government debt, but there is absolutely no reason why this should necessarily be so. The U.S. Federal Reserve could purchase Commercial Paper or Bankers Acceptances instead of Treasury Bills and Government Securities, and the Bank of England could equally well buy or sell commercial paper instead of Treasury Bills whenever it wishes to adjust liquidity in the system. Indeed the Fed and the Bank of England do buy and sell private sector debt instruments in the course of their open market operations.** The crucial point is that irrespective of the particular instrument employed in these central bank operations, there will be a multiple expansion effect or a multiple contraction effect on the banking system as a whole resulting from the original purchase or sale by the central bank.

In short, the proposition that Hong Kong's lack of government debt makes it difficult to establish a Monetary Authority or central bank is a red herring. The only logical consequence is that the assets of the monetary authority would have to be comprised of instruments other than government debt, i.e. foreign exchange or private sector debt instruments such as export bills or commercial paper.

* This is a slightly revised version of the 'box' which was published in AMM in March-April 1979.

** e.g. Between Oct. 1981 and Oct. 1982 the Issue Dept. of the Bank of England bought £6.7 bn. (net) in private commercial bills, and sold government securities worth £6.5 billion (net).

B. Interest Rates - What's Wrong with them as an Instrument of Monetary Policy ?

(1) THEORY

If one wants to control the market for any commodity it is necessary either to control the price of that commodity or to regulate the output or quantity produced. The same holds true for money.

The price of a unit of money is not interest rates, but what has to be given up to obtain that unit. For example, one Hong Kong dollar may purchase one orange, or fifteen US cents. So the price of money in Hong Kong (or elsewhere) may be expressed either in terms of the goods and services that must be foregone (or sold) to obtain that money, or in terms of units of foreign currency. Rather than attempting to regulate the amounts of goods and services that must be foregone to obtain a unit of Hong Kong currency the authorities generally take the sensible view that it is futile to try to control the price of every commodity or service, and they leave this process to the free market. In the good old days, however, they used to define the value of a Hong Kong dollar in terms of sterling (1935-72) or US dollars (1972-74). This meant in effect that the authorities stood willing to supply (sell) or take back (buy) an indefinite number of units of foreign currency for Hong Kong dollars at the pre-defined price.* In those days one could say the authorities controlled the price of Hong Kong dollars, but allowed the quantity of Hong Kong dollars to be whatever was necessary to keep Hong Kong's overall price level in line with price levels of overseas economies.

When they abandoned this system in 1972-74, it would have been logical and sensible for the Hong Kong authorities to go from a system of setting the price of Hong Kong dollars to a system of controlling the quantity of Hong Kong dollars, i.e. the money supply. In Japan, West Germany, Switzerland and more recently in Britain and the USA the authorities have moved to controlling the quantity of money by means of monetary base control, or direct control of the amount of central bank money as a means of regulating the aggregate money supply. For reasons which have been explained elsewhere in AMM, the Hong Kong authorities unfortunately chose not to do this, and ever since they have been tinkering with a makeshift structure in which neither control of the price nor quantity of money is possible.

Worse yet, instead of sticking with the two basic options of controlling the price or the quantity, they have sought to affect the quantity of money by exerting their influence over

* As in other colonies the Hong Kong authorities only dealt in banknotes (or certificates of indebtedness) and coin. As a rule they did not intervene on the open foreign exchange market.

interest rates. To do this they have brought in extensive new banking legislation, created an officially-sanctioned bank cartel to enforce regulated deposit interest rates, and imposed an artificial 3-tier banking structure.

But the problem is that interest rates are not the price of money, so there is no assurance - even assuming the authorities could have any precise influence on the whole spectrum of interest rates - that their influence would be effective in regulating the quantity of money.

Interest rates are the cost of credit i.e. the cost of renting money for a specified period of time. When an individual or company places money on deposit at a bank he can obtain some rent in the form of an interest payment, and the bank in turn is able to lend out that money as a means of payment to a needy borrower for a similar payment of rent which will normally include some "spread" that varies with a host of factors such as the creditworthiness of the borrower, the competitiveness of the credit market, and the efficiency of the bank's administrative operations. Because interest rates are often loosely referred to as the 'cost of funds' or the 'cost of money' it is nevertheless highly probable that many people including Hong Kong's monetary authorities do indeed think of interest rates as the cost or price of money, and hence they are led to believe that if only they can control this "price", then they can somehow control the quantity of money. Alas, this is not so.

In a system where deposit interest rates are controlled the main effect on holders of money will be to affect not the amount of money they hold in absolute terms, but only in relation to their total assets. If interest rates are held too low, there will be little incentive to hold assets in the form of money, and people will try to spend this money in an effort to reduce their money holdings as a proportion of their assets. The result of the whole community trying to spend this money simultaneously will be to drive up prices to the point where people feel that the amount of money they hold is once again at the right level as a proportion of their total assets. Conversely if interest rates are fixed too high there will be a clear incentive for the public to build up its money balances relative to other assets by holding back on expenditures, leading to a general slowdown in economic activity and falling prices until an equilibrium has been restored. So to be successful in controlling deposit interest rates as a means of regulating the money supply and keeping inflation under control the authorities must know precisely how much money the community collectively wishes to hold in relation to its other assets at any given level of interest rates.

On the other side of banks' balance sheets, in a system where bank lending rates are controlled, the main effect will be on the rate of credit creation by the banks. If bank lending rates are set too high borrowers will be dissuaded from drawing down credit lines, and banks will find themselves with excess funds which they will either lend to other banks at lower rates, so the interbank rate will fall, or they will buy

already existing credit instruments (CDs, bonds etc.) bidding up their price and forcing down their yield. The rate of new credit creation will tumble, and the yields on existing marketable credit instruments will fall, encouraging borrowers to resort to these other credit instruments rather than borrowing from the banks at the high fixed rates. Bank lending will decline, but bank holdings of bonds and other investments will rise i.e. the form of credit will change, but the aggregate amount may not. Conversely if bank lending rates are set too low, borrowers will be encouraged to draw down and even increase their credit lines, and banks will find themselves short of funds, and they will bid up interbank rates as they try to borrow from other banks or they will sell credit instruments such as bonds and CDs which they hold as investments. New credit creation by the banks will soar, and yields on existing instruments will rise. Bank lending will expand at the expense of other forms of credit instruments, but once again aggregate credit creation may not alter.

(2) APPLICATION

In Hong Kong's financial system alternative forms of credit instrument other than bank credit are relatively few and underdeveloped. Accordingly the main effect of bank lending rates being set too high or too low is probably on the rate of overall credit creation since there will be relatively little switching between types of credit instrument as occurs in financial markets with a more diversified range of financial instruments.

The direct implication of this analysis is that in Hong Kong credit creation will tend to alternate between being too fast and too slow, depending on whether bank lending rates are set too low or too high. Examination of the recent pattern of bank credit creation certainly seems to bear this out. Moreover, the controls on deposit interest rates will tend to amplify the effects of unstable credit growth because when deposit interest rates are too low people will tend to spend more in an attempt to reduce the amount of money they hold in relation to other assets, thus adding to the effects of excess credit creation when bank lending rates are too low. Conversely, when deposit interest rates are too high people will tend to spend less in an attempt increase their money balances in relation to other assets, thus intensifying the effects of the drying up of credit when bank lending rates are too high.

Thus the basic explanation for Hong Kong's boom-bust cycle is that interest rates are first an inefficient and very indirect way of controlling the money supply, and second, they tend to alternate between being too low for much of the business cycle (thus encouraging excess credit creation, a rapid acceleration of spending, booming property and stock prices, ultimately resulting in generalised inflation and a depreciating currency), and too high for the other part of the cycle (as when Mr. Brembridge finally forced the banks to raise their prime rates to 20% in October 1981, thus precipitating a sharp credit contraction, a downturn in spending, and the subsequent property and stockmarket crash).

In conclusion, the elaborate and openly discriminatory 3-tier banking system which was designed to protect the interest rate agreement turns out to have feet of clay. The intricately designed 3-tier system was intended to ensure, in the then Financial Secretary Haddon-Cave's words, "that an effective interest rate agreement is available as an instrument of monetary policy". Instead, it turns out not to be a dependable instrument at all (and this is basically why central banks elsewhere have abandoned interest rate controls). Rather, it has bequeathed to Hong Kong a system which virtually guarantees monetary instability in the shape of periods of excess credit creation and rapid money growth resulting in massive spending binges by Hong Kong's entrepreneurs and consumers alternating with periods of money and credit contraction bringing on sharp corrections to the property and stock markets and to the overall growth rate of the economy.

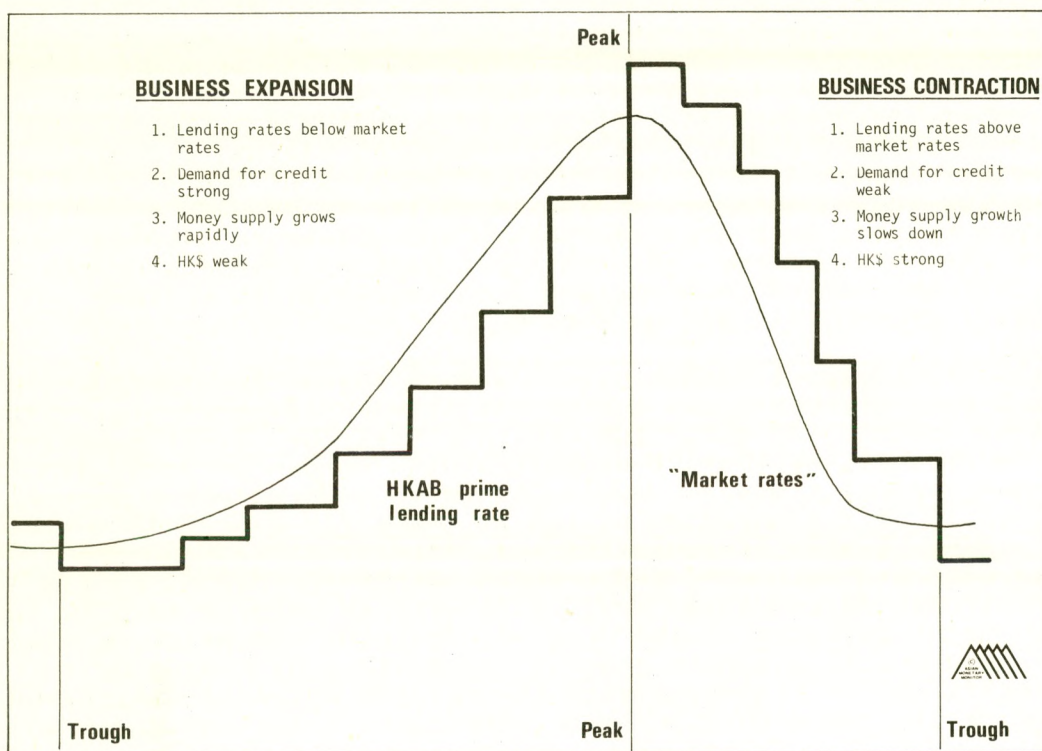
In retrospect Haddon-Cave's second reason for introducing the 3-tier structure has a bitterly ironic flavour to it. "The second reason", he said "for creating this three-tier structure is to protect the smaller deposit-taking companies from cut-throat competition which would, in turn, undermine the general stability of our monetary system at least for a period". What he meant was that if the banks were finally to tear up the interest rate agreement and compete openly for deposits, the deposit-taking companies would find it very hard to compete and some might go under in the ensuing struggle. In practice what has happened is that the general instability of Hong Kong's monetary system (together with the reforms which were supposed to cure it) has undermined the property market, leading to a collapse in the collateral or security against which many DTCs had lent, and a drying up of the income of numerous borrowers who are now unable to pay interest or repay the principal. At the same time the DTCs have been deprived of their access to short-term deposits by explicit legislation, and their credit lines for interbank funds have also been restricted. So the combination of the general credit contraction associated with the interest rate agreement and the simultaneous introduction of a three-tier banking structure has hit deposit-taking companies on both sides of their balance sheets, and in doing so has precipitated a financial crisis broadly comparable to the secondary banking crisis in Britain in 1973-74.

(3) CONCLUSION

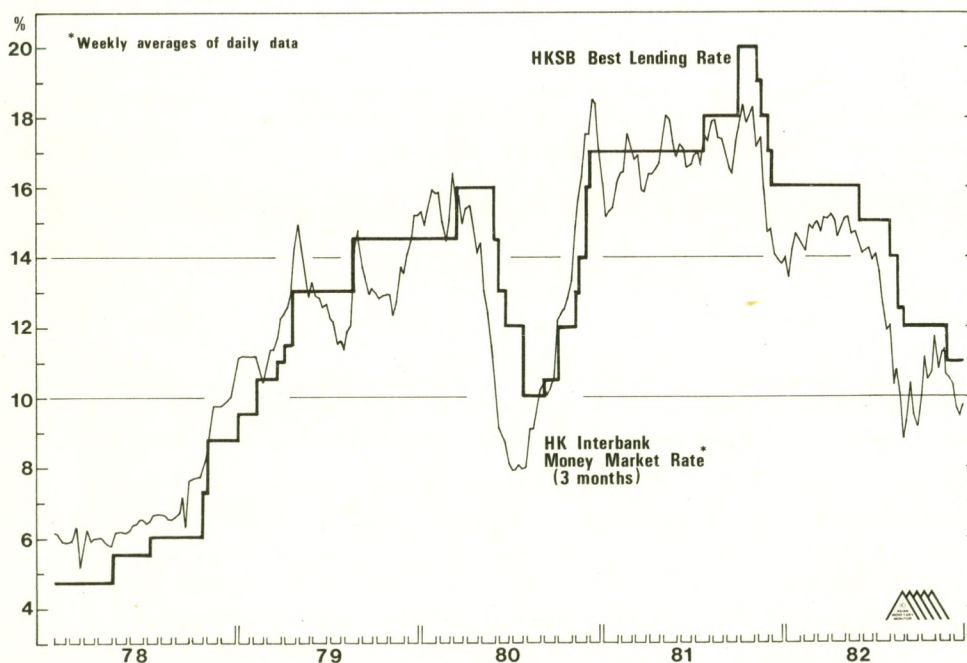
The interest rate agreement is obsolete and should be scrapped. First, its original *raison d'être* is no longer valid. Second, its current justification is manifestly unsound. Third, it is more likely to have a destabilising influence on Hong Kong's financial system than to provide a stabilising effect.

The original *raison d'être* for the Hong Kong Association of Banks' interest rate agreement dates back to the period 1958-64. During this period there was free competition among the licensed banks for deposits. During the most intensely competitive phase, in 1963, local banks were prepared to pay rates as high as 0.9 per cent per month on 12-month time

IN THEORY,



AND IN REALITY....



A HYPOTHESIS FOR THE HONG KONG CREDIT CYCLE

In any system where prices are regulated markets will not clear. Accordingly demand for the commodity in question will tend to be either excessive or far below the amount that could be offered at that price.

In the market for bank credit the same principles apply. When interest rates are fixed too low, the demand for credit will be very strong, and consequently credit expansion and money supply growth will tend to be very rapid. Conversely when interest rates are fixed too high, the demand for credit will be very weak, so that credit creation and money supply growth will tend to slow down.

In Hong Kong interest rates are set by a committee of the Hong Kong Association of Banks (HKAB) which is a legalised banking cartel. Its deliberations are directly influenced by the Financial Secretary and the Secretary for Monetary Affairs. The licensed banks are obliged to abide by the so-called Interest Rate Agreement on customer deposits of less than 12 months maturity and under HK\$500,000. Banks individually set their lending rates depending on the cost and source of their deposit bases, but in practice the rates are fairly uniform. These 'prime' or 'best' lending rates are the key rates. Because the committee meets just once a week (it used to be fortnightly) and because the agreed rates tend to reflect the authorities' view of where rates should be (or where the exchange rate should be) rather than actual market forces these lending rates are somewhat rigid, and they tend to lag behind developments in the market.

During the expansion phase of the business cycle the demand for credit will be growing as trade and business activity pick up, as investment in property, capital equipment and inventories accelerate, and as inflationary expectations rise. Typically free market interest rates will run ahead of bank lending rates, and because lending rates will appear cheap relative to market rates or relative to inflation the demand for credit will be extremely strong. Bank credit and money growth will grow very rapidly so that despite the rising trend of interest rates the Hong Kong dollar will tend to be weak.

Gradually, as fears about overheating, speculation, inflation and a weakening HK\$ intensify, the authorities and the HKAB will agree on the need to take action. Right at the peak of the business cycle they will finally jack up lending rates above 'market' rates, just as they did in October 1981.

Conversely during the contraction phase of the business cycle the demand for credit will be weakening as business activity and trade slow down, as plans for investment in property development, capital equipment and inventories are shelved, and as the inflation psychology gives way to a deflationary mentality. Because bank lending rates are now above free market rates, and because lending rates will appear high in relation to the falling inflation rate, the demand for credit will be weak. Bank credit and money growth will grow more slowly so that despite falling interest rates the Hong Kong dollar will tend to be strong.

Finally, as fears about recession and unemployment increase, and as a strengthening HK\$ discourages an export-led recovery the authorities and the HKAB will at last agree to get the economy moving again. Right at the trough of the business cycle they will allow lending rates to drop below 'market' rates, and the whole process will start all over again.....

deposits, and 0.5 per cent per month on 7-day call deposits. The competition for deposits combined with the lack of any required liquidity ratios for the banks (which were not introduced until the 1964 Banking Ordinance) led to dangerously low levels of liquidity among some of the smaller banks. According to Dr. Jao the average liquidity ratio for the banking system declined from 53.3% in 1955 to 34.3% in 1961, but since this latter figure was simply an average for the industry, the more venturesome banks were probably operating with liquidity ratios well below 20%. Among such banks a deterioration in business standards followed, and resources were severely stretched. In addition, the 1961 boom on the property and stock markets encouraged a crop of irregularities in management and business methods. Finally, a wild scramble for a two new issues on the stock market (Kowloon Motor Bus and Jardine Matheson) drained funds from the small banks, which, together with the circulation of malicious rumours precipitated a run on the Liu Chong Hing Bank (June 14-16, 1961).

Although the Liu Chong Hing affair ultimately led to the Banking Ordinance of 1964 and the imposition of liquid asset ratios, it did not spell an immediate end to the interest rate war. In September 1961 the Hong Kong and Shanghai Banks' subsidiary Wayfoong Finance Ltd. sparked off the next phase by raising its deposit rates for 1-year to 3-year deposits from 6% to 7%, while the parent bank also raised its rates for 6 to 12 month deposits to 6½%. "These moves by the largest bank and its subsidiary came like a bombshell, and were widely interpreted, especially by the Chinese banks, as an attempt to monopolise the banking business". (Y.C. Jao: Banking and Currency in Hong Kong, Macmillan 1974, p.240) In this atmosphere of mutual distrust attempts by the Exchange Banks' Association to work out an agreed rate structure failed to produce any agreement until July 1st 1964, and then only under the threat that non-signatories would be prohibited from use of clearing facilities, causing their cheques to be subject to a penalty tax.

It is not easy today to disentangle the rights and wrongs of this ancient dispute, but some conclusions may be drawn. First, free competition among the banks was generally good for depositors who benefitted from competitive deposit interest rates. The only serious threats to the stability of the banking system as a whole came from illiquidity, capital inadequacy, and instances of malpractice among the more aggressive banks which then became prone to bank runs. Illiquidity was a problem which the Banking Ordinance of 1964 was supposed to address. (In fact it was not until the Ordinance was revised in 1967 that the liquidity requirements became sufficiently stringent to ensure that banks did indeed have positive net liquid assets.) The problem of capital adequacy has been dealt with in recent years by increasing the capital requirements of licensed banks (and DTCs), which means that banks have ample capital to finance any temporary adverse trend in spreads. Tighter supervision and more careful safeguards against the abuse of depositors' funds by directors or bank management have helped to reduce the more obvious malpractices, but it would be naive to pretend that there will

not again be cases of abuse in the future.

Nevertheless, the current regime of liquid asset ratios, (despite all their shortcomings in other respects), larger capital requirements and tougher conditions for entry to the Hong Kong banking market mean that Hong Kong's banks are liquid enough, strong enough, and sufficiently well-managed to be able to offer their depositors competitive interest rates on deposits. To argue that the interest rate agreement is still necessary in today's environment is to ignore all the improvements in supervision and control which have occurred over the past twenty years. For these reasons we believe the interest rate agreement is obsolete.

Although there are occasional (and in our view misguided) attempts to defend the interest rate agreement on the grounds that free competition for deposits would be worse than having the present day banking cartel, the primary justification for the HKAB is that the interest rate agreement is the government's only effective tool of monetary policy. Without it, the official argument goes, the authorities could exercise no significant influence on the growth of money and credit. However, it can easily be shown that money and credit growth have been ill-behaved rather than well-behaved even under the interest rate agreement, with money and credit fluctuating widely and pro-cyclically, amplifying the instability of Hong Kong's business cycle. One is forced to conclude that the much-vaunted effectiveness of the interest rate as a tool of monetary policy is highly dubious. More important, the discrimination which the interest rate agreement imposes on the small depositor might be excusable if the interest rate cartel were properly effective as an instrument of monetary policy, but even that is very much open to question (see pp.18-20). In our view these current justifications for continuing with the interest rate agreement simply do not stand up to rigorous examination.

Finally, the third and perhaps the best reason for scrapping the interest rate agreement is that it can be clearly shown to contribute to instability in Hong Kong's financial system rather than to be a force for stability. First, pegged interest rates contribute to unstable money growth on the domestic side (see box pp. 22-23), but secondly, pegged interest rates will tend also to contribute to short-term instability in the foreign exchange market. For the more rigid domestic rates are, and the larger the proportion of domestic deposits that are covered by the fixed rate agreements, the more significant this instability will become. Interest rates, spot exchange rates and forward exchange rates are more or less locked together through the interest parity theorem. Consequently if interest rates are rigidly pegged and there is no central bank undertaking to stabilise the foreign exchange market, much of the variability in the demand for and supply of credit will show up in the foreign exchange market.

If the interest rate agreement could be shown to serve depositors and at the same time it could be shown to contribute materially to stability in Hong Kong's financial system, there

would be a good case for continuing with it. However, the obvious discrimination against small depositors (under HK\$500,000), and the manifest instability of the behaviour of Hong Kong's monetary aggregates only reinforce the grave doubts which theoretical examination suggests as to the value of the interest rate agreement.

While it may seem neat and tidy from a bureaucrat's standpoint to have all banks offering virtually identical deposit interest rates, such tidiness is more apparent than real because where price competition is prohibited, non-price competition will flourish. However, for all its virtues non-price competition will not solve the fundamental shortcoming of the interest rate agreement, namely ensuring that the quantity of money in Hong Kong grows at a pace consistent with either equilibrium in the balance of payments at a particular exchange rate or (assuming a floating exchange rate) overall price stability in the domestic economy.

To summarise and conclude, the original *raison d'être* for the interest rate agreement has long since vanished, it currently fails to do the task it is purported to do (promote monetary stability in Hong Kong), and it is probably actually contributing to instability by encouraging alternately excessively fast and slow money growth. Moreover, the agreement is irrelevant to a more soundly based reform of Hong Kong's monetary system, and it should therefore be allowed to wither and die as and when more thorough-going legislation along the lines suggested elsewhere in AMM is introduced.

C. The Exchange Fund's Borrowing Scheme : A Twist on Operation Twist

Concerned at the persistently excessive growth of money and credit, and acknowledging the fact that the authorities had only a consultative role in setting interest rates, the Hong Kong government worked out a scheme in November 1981 whereby the Exchange Fund was going to influence money market rates directly.

The plan was outlined in Legislative Council on December 9th 1981 by Financial Secretary John Bremridge:

"A scheme has now been implemented to enable the Government through the Exchange Fund to influence the level of money market rates. Briefly, the Exchange Fund can bid through one or another of its major bankers in Hong Kong for deposits in the money market in the short end (say one week to one month). This will increase the demand for funds in the market. The Exchange Fund then holds the funds it has taken off the market for one or two weeks, or even longer, so that the supply in the market is not increased to match the increase in demand. That will tend to push up, or to hold up, interest rates at the short end. When market participants come to accept that the tightness in the market is not a temporary aberration, the Exchange Fund will lend out the deposits it has taken at the longer end of the market (maybe three to six months) and, if possible, at a higher rate of interest.

"If the tightness in the domestic money market pushes interest rates to a higher level than banks or deposit-taking companies needing local funds are willing to pay, they will have to borrow foreign currency, usually US dollars, with which to buy Hong Kong dollars. That will directly support the exchange rate of the Hong Kong dollar. At the same time the higher level of these interest rates will be passed on to the cost-of-funds (HIBOR) customers as their drawings are rolled over.

"This mechanism will be most effective when local interest rates are rising, or when they are stable and no downward movement is expected in the next few weeks or months. If an imminent downward movement is expected there is little incentive for a bank or deposit-taking company to borrow funds in the three to six months range, and so to lock in what may prove to be an expensive interest rate. Conversely when rates are rising they may be glad to lock in an interest rate which may prove to be cheap.

"I must emphasize that Government is using, and will use, this new weapon in their monetary armoury selectively and cautiously. It is certainly not a panacea. Nor do we intend to be operating constantly in the money market."

This apparently ingenious innovation has two noteworthy features. First, if the funds borrowed by the Exchange Fund are not utilised i.e. if the funds are not spent by drawing a cheque against the loan, it is questionable whether there is any sense in which the money is "taken off the market". It is rather like bidding for shares on the stock market and so pushing the price up, and then not taking delivery. Ultimately the price of the shares must come back down again. Similarly the Exchange Fund's scheme will not really affect interest rates because it does not affect the aggregate amount of funds available in the way that central bank open market operations do; it does not remove the funds from banks' balance sheets or initiate a multiple contraction process in the way that central bank sales of securities would do.

Second, insofar as the Exchange Fund borrows short and lends long it is simply imitating the long discredited Federal Reserve tactic known as "operation twist". This trick was practised in the following manner. In November 1960 and in 1961 the Fed wanted to lower long term rates to encourage domestic corporate investment while holding short term rates up to safeguard the balance of payments against short term capital outflows.* Accordingly it sold (or did not buy) short term Treasury bills and bought roughly corresponding amounts of long term paper. The initial effect was to push up short rates and to lower long rates, i.e. to "twist" the yield curve. But subsequently the private sector responded by shifting funds from longer term instruments which were now less attractive to shorter term instruments which were now more attractive. Also, long term capital, though less internationally mobile than short term capital at the time, was discouraged from flowing into the USA, further undermining the Fed's intentions.** In other words the redistribution of funds which the Fed sought to produce by its operations was soon negated by the response of private sector investors at home and abroad to the now distorted rate structure. The experiment was therefore abandoned. Yet exactly twenty years later the Hong Kong authorities have introduced a variant of the same scheme.....

To conclude, in our view it is highly dubious whether the scheme actually works as it is purported to do, and in any case the response of the private sector to such artificial rate distortions is likely to undo their effects within a short period of time.

* See Milton Friedman and Anna Schwartz, A Monetary History of the United States (NBER and Princeton Univ. Press) pp. 633 and 636.

** See Leland B. Yeager, International Monetary Relations (Harper & Row, 2nd edition) p. 569.

D. Intervention in the Foreign Exchange Market - Why it doesn't Work in Hong Kong

Under an orthodox central banking system described in section 4 intervention in the foreign exchange market is successful because the central bank's transactions produce a reduction in the quantity of bank reserves, and hence tighten the money supply. In the classical pre-1972 system in Hong Kong a similar result was achieved even though the Exchange Fund was a passive participant in the process. In both systems the formal pegging of the exchange rate worked because balance of payments surpluses or deficits at any given exchange rate produced a corresponding multiple expansion or multiple contraction of bank credit or deposits which in turn induced adjustments in the economy that tended to correct the original source of the problem. This self-correcting mechanism in Hong Kong was 'automatic' in the sense that the Exchange Fund was a passive participant in the process in contrast to the orthodox central bank case where the intervention was explicit and discretionary.

However, the new Hong Kong dollar accounts of the Exchange Fund with the licensed banks (actually with two largest note-issuing banks), activated and enlarged in 1972-74 to meet the need to intervene actively in the foreign exchange market, do not have comparable multiple expansion or multiple contractionary effects (see box pp. 30-31).

If the authorities wish to stop the Hong Kong currency depreciating, the Exchange Fund will buy Hong Kong dollars in the foreign exchange market from private sector owners of those deposits who will receive foreign currency deposits in exchange. The problem is that the Exchange Fund nowadays deposits the Hong Kong dollars it receives from such support operations back in the banking system, where the funds are again lent out, so there is no material change in the size of banks' balance sheets - only a transfer in the ownership of HK\$ deposits from the private sector to the Exchange Fund.

Similarly, if the authorities were in the enviable position of wishing to limit an upward appreciation of the HK\$ exchange rate, they would be equally powerless to do anything about it. The Exchange Fund would buy foreign currency from private individuals or corporations in the market and sell Hong Kong dollars to them. Insofar as the Exchange Fund is a seller of Hong Kong currency this would keep the currency down momentarily, but as soon as the authorities had no more Hong Kong dollars to sell the effectiveness of their intervention would be at an end. The net effect would be a transfer of deposits between the Exchange Fund and the private sector, but with no multiple expansion of the banking system as a whole. So the old adjustment mechanism, whereby the money supply expanded until the balance of payments was corrected by increased spending on imports or capital outflows (both induced by the monetary expansion), no longer operates.

THE MULTIPLE CONTRACTION PROCESS IN AN ORTHODOX BANKING SYSTEM - HOW INTERVENTION WORKS

STAGE 1: STARTING POINT

Central Bank	
Foreign Exchange	600
Banknotes Deposits of banks	550 50

Commercial Banks	
Banknotes Deposits at Central Bank	50 50
Deposits	5000
Loans and Investments	4900

Non Bank Public	
Banknotes Deposits	500 5000
Money Supply:	5500

Banks' Deposit/Reserve ratio*: 50
Non bank public's D/C ratio*: 10

(EQUILIBRIUM)

* These are assumed to be the desired ratios in each case.

STAGE 2: INTERVENTION

Central Bank	
Foreign Exchange	590
Banknotes Deposits of banks	550 40

Commercial Banks	
Banknotes Deposits at Central Bank	50 40
Deposits	4990
Loans and Investments	4900

Non Bank Public	
Banknotes Deposits	500 4990

Banks' Deposit/Reserve ratio: 55
Non bank public's D/C ratio : 9.98

(DISEQUILIBRIUM)

STAGE 3: EQUILIBRIUM RESTORED (figures have been rounded)

Central Bank	
Foreign Exchange	590
Banknotes Deposits of Banks	541 49

Commercial Banks	
Banknotes Deposits at Central Bank	49 49
Deposits	4916
Loans and Investments	4818

Non Bank Public	
Banknotes Deposits	492 4916
Money Supply:	5408

Banks' Deposit/Reserve ratio: 50
Non bank public's D/C ratio : 10

(EQUILIBRIUM)

Original intervention: -10
Monetary contraction : 5408-5500=-92.

THE SYSTEM IN HONG KONG - WHY INTERVENTION DOESN'T WORK

STAGE 1: STARTING POINT

Exchange Fund	
Foreign Exchange 600	Certificates of Indebtedness (CIs) 600

Commercial Banks	
CIs 600	Banknote issue 600
Till cash 100	Deposits 5000
Loans and Investments 4900	

Non Bank Public	
Banknotes 500	
Deposits 5000	
Money Supply : 5500	

Banks' Deposit/Reserve ratio*: 50
Non bank public's D/C ratio*: 10
(EQUILIBRIUM)

STAGE 2: INTERVENTION

Exchange Fund	
Foreign Exchange 590	CIs 600
HK\$ Deposits 10	

Commercial Banks	
CIs 600	Banknote issue 600
Till cash 100	Deposits of non bank public 4990
Loans and Investments 4900	Deposits of Exchange Fund 10
Foreign assets 10	Foreign currency deposits of non bank public 10

Non Bank Public	
Banknotes 500	
Deposits 4990	
Money Supply : 5490	
Foreign currency deposits 10	

Banks' Deposit/Reserve ratio : 50
Non bank public's D/C ratio : 9.98
(DISEQUILIBRIUM)

STAGE 3: EQUILIBRIUM RESTORED (figures have been rounded)

Exchange Fund	
Foreign Exchange 590	CIs 599
HK\$ Deposits 9	

Commercial Banks	
CIs 599	Banknote issue 599
Till cash 100	Deposits of non bank public 4991
Loans and Investments 4900	Deposits of Exchange Fund 9
Foreign assets 10	Foreign currency deposits of non bank public 10

Non Bank Public	
Banknotes 499	
Deposits 4991	
Money Supply : 5490	
Foreign currency deposits 10	

Banks' Deposit/Reserve ratio : 50
Non bank public's D/C ratio : 10
(EQUILIBRIUM)

Original Intervention : -10
Change in money supply: -10

In other words deposits 'withdrawn' from the banking system by Exchange Fund are not withdrawn at all, they are merely redeposited with the banking system. Conversely deposits 'injected' into the system by Exchange Fund intervention to keep the HK\$ rate down are not really new additions to the system at all, they are merely transfers of deposits from the government sector to the private sector with no effect on the overall size of licensed bank balance sheets.

A useful way of looking at the situation today is to regard the Exchange Fund as if it were just any large corporation. (The Exchange Fund happens to have the special privilege of enjoying the seignorage from the issue of Certificates of Indebtedness, but that is not material to the argument here.) If the Exchange Fund buys or sells foreign exchange through the banking system its transactions are just like those of any other large corporation. If the Exchange Fund Corporation buys Hong Kong dollars and the ABCD Corporation sells Hong Kong dollars the end result is a transfer of the ownership of deposits, not a change in the total quantity of deposits. This is quite a different result from the intervention operations of the orthodox central bank where sales and purchases of foreign currency for domestic currency lead respectively to a multiple contraction or expansion in the total money supply.

The only other peculiarity of the Exchange Fund in comparison with other public corporations is that under legislation introduced in 1979 the Exchange Fund can arrange to have its Hong Kong dollar deposits treated either as deposits of a bank (in which case they must be 100% covered by so-called liquid assets), or it can have them treated as deposits of a normal corporation or individual (in which case they are subject to the standard 25% liquid asset ratio). Official assertions to the contrary notwithstanding, this facility has no monetary significance whatsoever. Switching deposits from one category to the other may affect the distribution of bank credit (i.e. the form of bank assets), but it has no effect on private sector holdings of deposits or the money supply properly conceived. (There may be a small statistical effect, but that is because the 'money supply' in Hong Kong is mistakenly defined to include deposits of the authorities, not because the public's holdings of money have changed.)

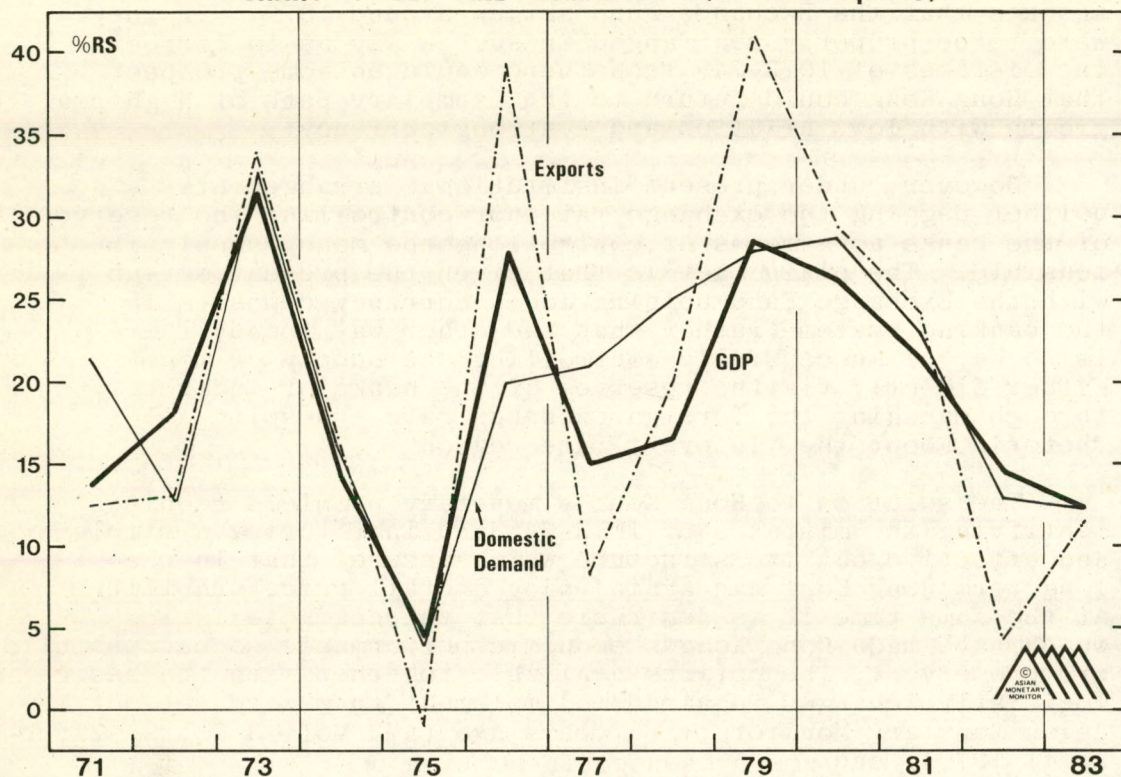
It is not surprising in view of these fundamental deficiencies in the Hong Kong banking system that the money supply continued to balloon as long as interest rates were kept too low, and then stopped growing abruptly when bank lending rates were finally raised prohibitive levels. Periodic government intervention in the foreign exchange market has had virtually no effect on this process. Since intervention is not effective under present institutional arrangements it is not surprising that the government is reluctant to manage the exchange rate in the way that Australia, Malaysia, Singapore and other economies have done in recent years. But this should not be allowed to remain an excuse for inaction. Active intervention may have proved futile given the present system, but that does not necessarily mean that another set of

of institutional arrangements could not be effective. In particular there is nothing sacrosanct about the new HK\$ accounts that the Exchange Fund set up around 1972. If they were to be properly rearranged in such a way as to correct the mistakes of 1972-74, then there would be some prospect that Hong Kong could return to the exemplary path of high real growth with low inflation and a strong currency.

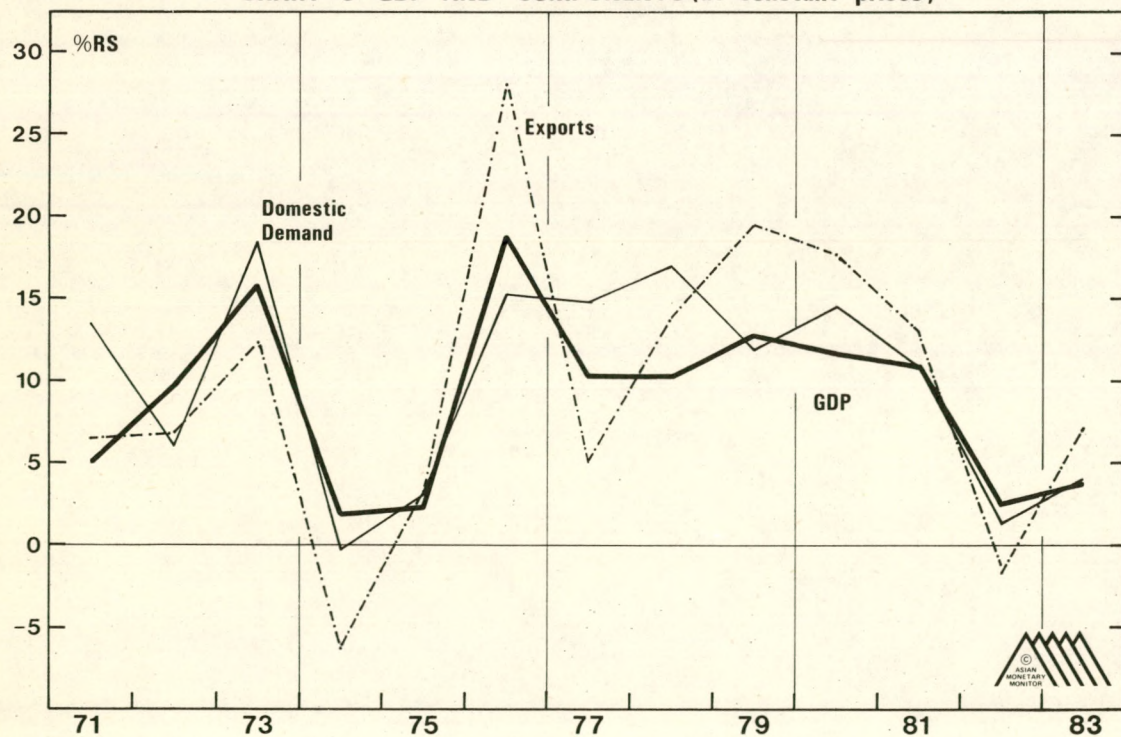
However, under present institutional arrangements neither pegging the exchange rate nor controlling the reserves of the banks as a means of controlling the money supply is feasible. The plain fact is that given the present set-up with the Exchange Fund holding local currency deposits in the banking system (rather than the other way round) there is no way of successfully controlling the supply of money either directly via the reserves of the banks or indirectly through managing the foreign exchange rate - despite all rhetoric about the "interest rate weapon".

The solution to Hong Kong's monetary problems requires rectifying the mistakes of 1972-74, and instituting a simple and effective banking structure which ensures that in the long term Hong Kong can again enjoy overall price stability. At the same time it is desirable that the characteristics which have made Hong Kong's economic performance so successful are preserved. The options available together with the basic legislative changes required to implement them were set out in Asian Monetary Monitor three years ago (AMM Vol. 3 No. 2, March-April 1979), and are presented in section 5.

HONG KONG
CHART 4 : GDP AND COMPONENTS (at current prices)



HONG KONG
CHART 5 : GDP AND COMPONENTS (at constant prices)



4. THE OLD AUTOMATIC ADJUSTMENT MECHANISM - HOW IT OPERATED AND HOW IT WAS UNDERMINED

SUMMARY

1. The adjustment mechanism is the process by which economic activity and the price level in one economy adjust to economic activity and the price level in other economies.
2. The adjustment mechanism is not simply the change in the composition of the GDP but a much broader process, which may be characterised in three stages. The first stage involves the balance of payments and its impact on the banking system. The second stage concerns the impact of changes in the money supply on total spending in the economy, and the third stage concerns the feedback effect of greater aggregate spending (i.e. higher output and prices) on the balance of payments again.
3. This three stage process occurs in all economies; it is not unique to Hong Kong. What was different about Hong Kong (and other colonial economies) was the way in which the balance of payments impacted the banking system. The other two stages of the process were the same in Hong Kong as elsewhere.
4. The crucial difference between Hong Kong and other economies was therefore not so much in the sequence of events making up the adjustment process as in the way that the authorities (i.e. the Exchange Fund) participated in the adjustment process. In a typical orthodox central banking system the authorities participated (a) actively and (b) in direct response to the balance of payments, whereas under the Colonial Currency Board systems the authorities participated (a) passively and (b) only in response to the demand for banknotes, not in response to the balance of payments.
5. Hong Kong's adjustment mechanism was drastically undermined by the changes that were made to the financial system in 1972-74. Today the authorities are no longer passive, but they are powerless in the sense that they neither have the means effectively to control the quantity of money nor the ability to regulate systematically the exchange value of the Hong Kong dollar. It is the banks who now take the lead in the adjustment process through their discretionary power to create credit, and the exchange rate then alters to adjust the price level in Hong Kong to prices overseas. Hong Kong would benefit by implementing institutional changes which would restore control of the adjustment mechanism either to the authorities (by moving to a central bank) or to the old automatic mechanism (by reverting to a modified form of the pre-1972 system).

A. A Superficial View of the Automatic Adjustment Mechanism

In his lengthy analyses of the Hong Kong economy, the previous Financial Secretary frequently referred to the operation of the automatic adjustment mechanism. A careful reading of his speeches reveals three distinguishable phases which the Hong Kong economy could be considered to experience: 1) An equilibrium state when all components of the GDP were growing at the same rate, 2) a stage during which exports (or overseas demand) was growing more rapidly than domestic demand, and 3) a stage during which domestic demand was growing more rapidly than foreign demand.

The actual experience of the Hong Kong economy in nominal and real terms is shown in Charts 4 and 5 (p.34). As can be seen, the actual behaviour of the components of the GDP conforms roughly to the theoretical pattern depicted in Chart 6. In other words, periods in which domestic demand grows more rapidly than foreign demand tend to alternate naturally with the periods when foreign demand grows more rapidly than domestic demand. Occasionally both these components grow at similar rates, but this is rare.

However, the reason that these phases of faster and slower growth in the components occur is purely a result of arithmetic - it has nothing to do with the automatic adjustment process.

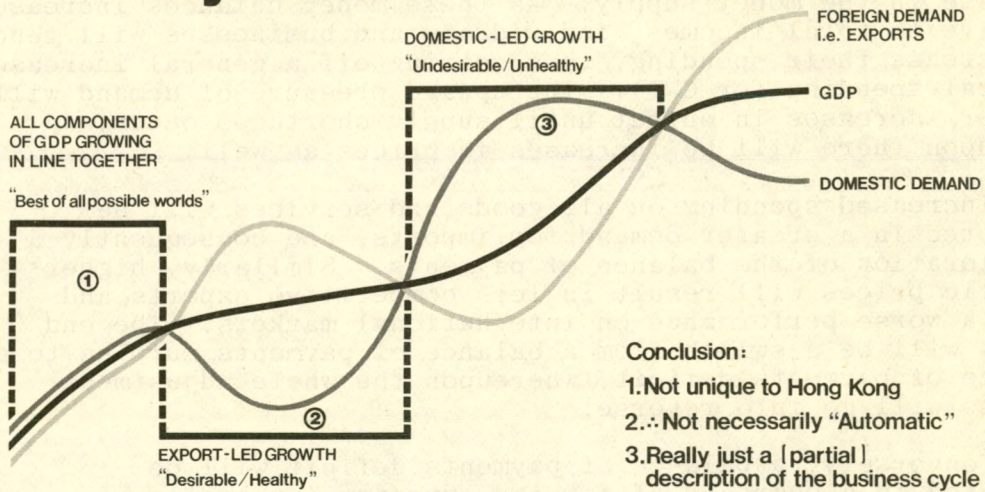
$$\begin{aligned}
 \text{GDP} &= \underbrace{\left(\begin{array}{c} \text{Private} \\ \text{Consumption} \\ \text{Expenditure} \end{array} \right) + \left(\begin{array}{c} \text{Government} \\ \text{Expenditure} \end{array} \right) + \left(\begin{array}{c} \text{Private Investment} \\ \text{Expenditure} \end{array} \right)}_{\substack{\text{(Domestic)} \quad \quad \quad \text{(Domestic)} \quad \quad \quad \text{(Domestic)}}} - \underbrace{(\text{Imports})}_{\text{(Domestic)}} + (\text{Exports}) \\
 &= \text{Domestic Demand Components} + \text{Foreign Demand (Exports)}
 \end{aligned}$$

Since the GDP can be defined as the sum of domestic and foreign demand, if one component is growing faster than the total, then the other component must be growing more slowly than the total. But there is nothing unique to Hong Kong about this process: it happens in all other economies too. Nor is there anything automatic about it except in an arithmetic sense which also applies to all other economies. Clearly, this is not an adequate description of the automatic adjustment mechanism.

Indeed, this description of the interaction of the different components of the GDP is only a very superficial account of the business cycle in that omits any reference to developments in the balance of payments and their impact on the banking system, or the link between changes in money and credit in the banking system and changes in domestic expenditures.

CHART 6

Haddon-Cave's Concept Of "Automatic Adjustment"~A Post Mortem



Conclusion:

1. Not unique to Hong Kong
2. ∴ Not necessarily "Automatic"
3. Really just a [partial] description of the business cycle
4. Omits money supply, the general or overall price level, and inflation

B. A More Comprehensive View of the Business Cycle

A more complete description of the business cycle requires integration of the balance of payments, the banking system, money and credit, their impact on output and prices, and finally the feedback effect of changes in output and prices on the balance of payments.

Under a system of fixed exchange rates a surplus on the balance of payments will be reflected in an excess of foreign currency on the foreign exchange market, which will either lead to an increase in the reserves of commercial banks, or at least an increase in their lending ability. The combination of increased receipts from abroad in the hands of domestic residents or increased lending by the banks will show up as an increase in the money supply. As these money balances increase relative to total incomes, individuals and businesses will tend to increase their spending, thus setting off a general increase in total spending (or GNP). The upward pressure of demand will trigger increases in output until supply shortages occur, whereupon there will be increases in prices as well.

Increased spending on all goods and services will be reflected in a greater demand for imports, and consequently a deterioration of the balance of payments. Similarly, higher domestic prices will result in less competitive exports and hence a worse performance on international markets. The end result will be a switch from a balance of payments surplus to a balance of payments deficit, whereupon the whole adjustment process will go into reverse.

Conversely, a balance of payments deficit will be reflected in a shortage of foreign currency (or excess of domestic currency) on the foreign exchange market, leading to a decrease in bank reserves and/or a decrease in banks' lending ability. The accompanying slowdown in monetary growth will tend to reduce the rate of growth of total spending or GNP, which will be reflected in some combination of reduced output and lower inflation. The general slowdown in spending will also show up in reduced expenditure on imports, and a consequent improvement in the balance of payments. Lower domestic prices will also improve international competitiveness, and the net result will be a switch from balance of payments deficit back to surplus, thus completing a full cycle of the adjustment mechanism.

To see why Hong Kong's adjustment mechanism is (or was) "automatic" it is necessary to look first at how this adjustment mechanism operates in an orthodox financial system with a central bank.

CHART 7

Characteristics Of The Business Cycle

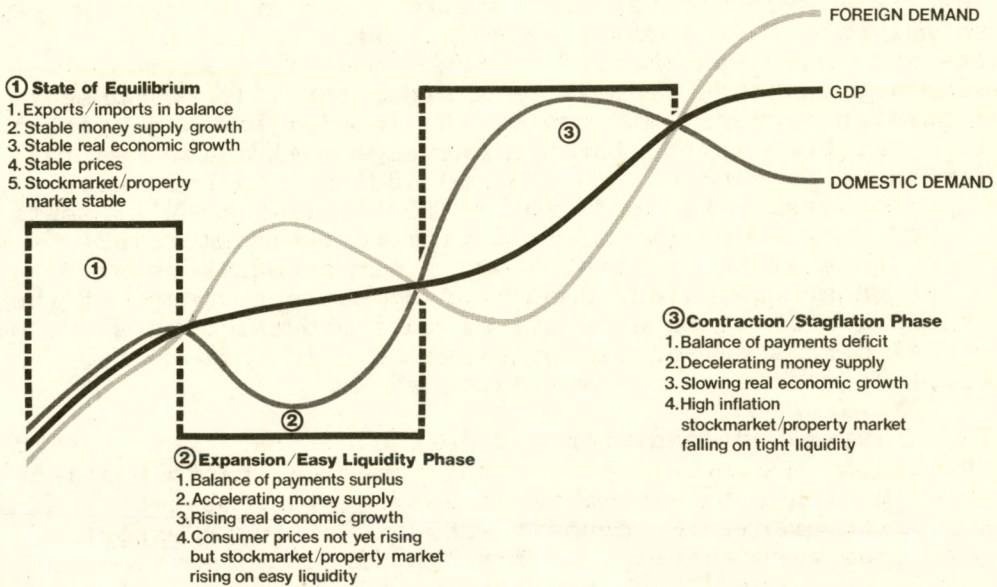
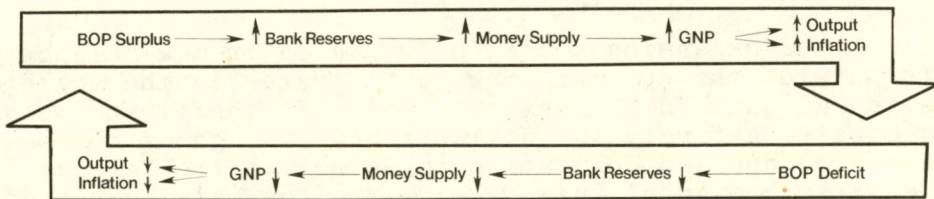


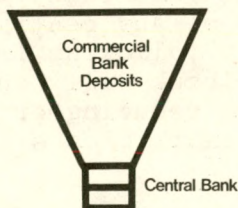
CHART 8

Outline Of The Adjustment Process,

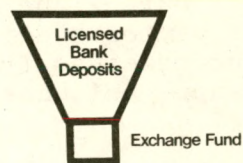


And Its Application To 2 Economies :

(1) Central Bank System



(2) Colonial Currency Board System



C. The Adjustment Mechanism in an Orthodox Central Bank System

Under a fixed exchange rate system (such as Bretton Woods) the central bank in a country experiencing a balance of payments surpluses was obliged to take corrective action. The mechanism was that the central bank stood ready to purchase the excess foreign currency offered on the foreign exchange market. When it intervened in the foreign exchange market the central bank purchased foreign currency, thus adding to its foreign currency reserves. This addition to the central bank's assets was matched by a simultaneous crediting of the commercial banks' accounts at the central bank, their accounts being credited with an equivalent amount of domestic currency at the fixed exchange rate. As a result of this process both sides of the central bank's balance sheet expanded. In contemporary parlance, the monetary base was expanded.

The provision of additional domestic currency reserves (or deposits at the central bank) to the commercial banks enabled them in turn either to expand their lending in domestic currency or to credit the deposit accounts of their exporter customers (who were earning the foreign currency remittances) in domestic currency. Such new lending or conversion of net foreign remittances into domestic deposits fuelled an increase in the domestic money supply which was gradually reflected in greater domestic expenditures via the same process as that described in connection with Chart 8.

A precisely analogous set of consequences was set in motion by a balance of payments deficit, starting with sales of foreign exchange by the central bank and ending with a reduced rate of growth of total spending.

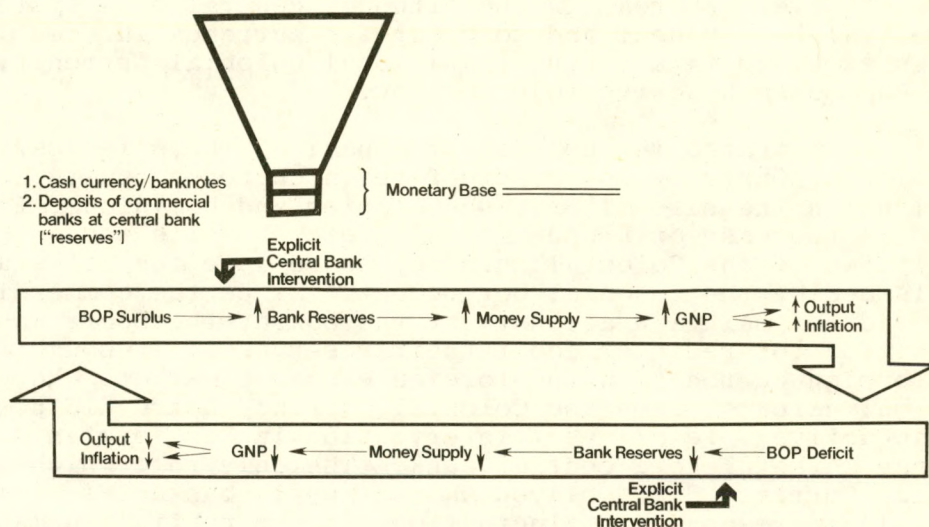
During the expansion phase following on from a balance of payments surplus the central bank participates in the adjustment process in two quite different respects. In the first instance it participates actively and deliberately (though of course it is in a sense under an obligation to do so) in the foreign exchange market to supply new reserves to the banking system. Second, as domestic expenditures increase so the demand for banknotes will grow - typically in line with consumer spending - and banks will draw down on their reserve accounts at the central bank to pay for the banknotes which will be passed on to bank customers. These two activities - supplying reserves to the banks and supplying new banknotes (and coin) to meet the demand for currency - are the hallmarks of any central bank.* Conversely, during the contraction phase following from a balance of payments deficit the central bank will tend to be draining reserves from the system and reducing or slowing down the supply of banknotes. On the liabilities side of their

* As we shall see, a colonial currency board differs from a central bank in that it only performs the second of these functions.

CHART 9

(1) Adjustment Mechanism

Under Orthodox Central Bank System



balance sheet central banks may or may not perform other functions (such as accepting deposits from the government or the general public), and on the assets side of their balance sheet they may buy or sell a greater or lesser range of financial instruments in the foreign exchange market or the domestic money market, but the really crucial point so far as the analysis of the adjustment process is concerned is that there are two distinct liability-side activities involved: supplying bank reserves and supplying banknotes. The supply of reserves is an active and conscious process in which the central bank has discretion to offset or not to offset balance of payments surpluses or deficits; the issue of banknotes is one in which the central bank is essentially passive, with the central bank responding to the natural fluctuations in the public's demand for banknotes which are conveyed from the general public to the commercial banks and thence to the central bank via the commercial banks' decisions to convert reserves to currency and vice-versa.

It is the deliberate, active supply of bank reserves by the central bank which prevents one from applying the phrase 'automatic' adjustment mechanism to economies with central banks.

D. The Adjustment Mechanism in a Typical Colonial Currency Board System

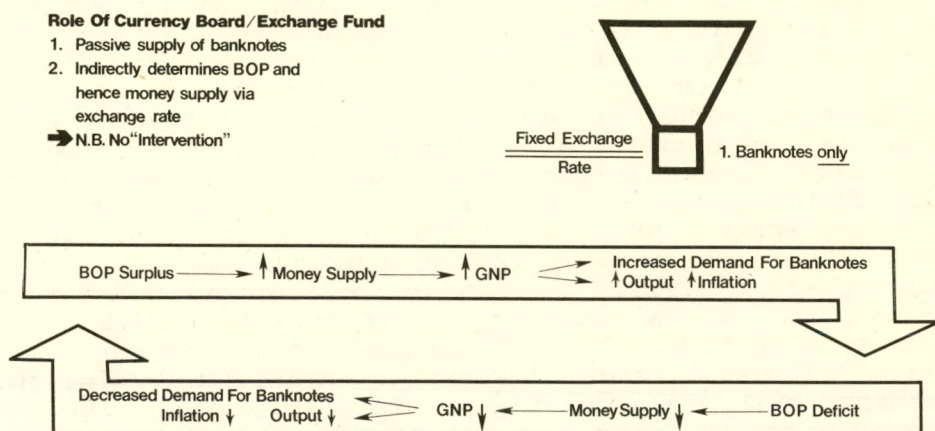
The typical Colonial Currency Board system was simply a variation of the standard fixed exchange rate system described above. However, whereas in the orthodox central bank system the central bank bought and sold foreign currency in the foreign exchange market, the traditional Colonial Currency Board had no such active role to play.

As illustrated in the diagram opposite, the sole assets of the Colonial Currency Board were foreign currency assets (sterling in the case of British Colonies and Dominions, French francs in the case of French Colonies etc.), while the only liabilities of the Colonial Currency Board were the notes and coin issued by the Colonial Government. Since the commercial banks did not maintain accounts at the Board, the Board was in no position to credit or debit their reserves if it bought and sold foreign currency in the foreign exchange market. Moreover, in normal circumstances the Colonial Currency Board did not play an active role of overt intervention in the foreign exchange market like a central bank. The only role which the Colonial Currency Board played was to supply banknotes or coin passively in response to fluctuations in the public's demand for currency. In terms of the diagram opposite, this function occurred towards the end of the adjustment process, not at the beginning as in the case of central bank intervention.

Instead of relying upon central bank-type intervention Colonial Currency Board systems relied upon the operation of market forces in the private sector to bring about the adjustment of business activity or prices in the colonial economy to the level of activity or price level of the metropolitan economy. In an orthodox central bank system commercial banks could sell excess foreign currency balances for their customers to the central bank, but in a Colonial Currency Board system it was assumed that the exchange rate was immutable and commercial banks were therefore taking no material risk in crediting their customers with the domestic currency equivalent of whatever foreign currency amount they were due. Since the commercial banks had to pay foreign currency to the Board only to obtain new banknotes, the process of monetary expansion was ultimately held in check only by the amount of net foreign currency balances held by the private sector. Thus during periods of balance of payments surplus when the private sector was in net receipt of foreign currency remittances, the banks could either lend more in local currency (which would be reflected in the growth of local currency deposit accounts) or obtain more banknotes and coin from the Colonial Currency Board. Conversely during periods of balance of payments deficits when the private sector was a net spender of foreign currency, the banks would find they could not both increase their loans and obtain more banknotes because their foreign currency position would be run down. The first process gave rise to a monetary expansion, the second to monetary contraction.

CHART 10

(2) "Automatic" Adjustment Mechanism Under Colonial Currency Board System



But at no time did the Colonial Currency Board actively participate in this process. The adjustment process was "automatic" in the sense that the switch from monetary expansion to contraction (and vice-versa) occurred as a direct result of the switch from balance of payments surplus to deficit (or deficit to surplus) in the private sector without the government or Currency Board taking an active role.

The only modification which is necessary to make this description applicable to the case of the Hong Kong is to note that banknotes in Hong Kong were not issued by the Exchange Fund itself but by certain commercial banks against Certificates of Indebtedness (CIs) issued by the Exchange Fund. However, to obtain the CIs the note-issuing banks had to pay foreign currency to the Exchange Fund, so in effect the banknotes were issued on government authority but at one remove. The Exchange Fund held the foreign currency assets which were the ultimate 'backing' for the note issue, but commercial banks actually printed and distributed the notes. In every other respect the operation of the automatic adjustment mechanism in Hong Kong was identical to its operation in other colonies.

The distinguishing feature of the 'automatic' adjustment process so far as Hong Kong (and other colonies) were concerned was that the authorities through the Exchange Fund did not and could not actively participate in adjusting the rate of monetary expansion in the colony to the exigencies of overseas economic activity or price levels overseas, and were obliged to allow the process of adjustment to occur 'automatically' through the private sector.

E. How the Adjustment Mechanism Worked to Align Price Levels

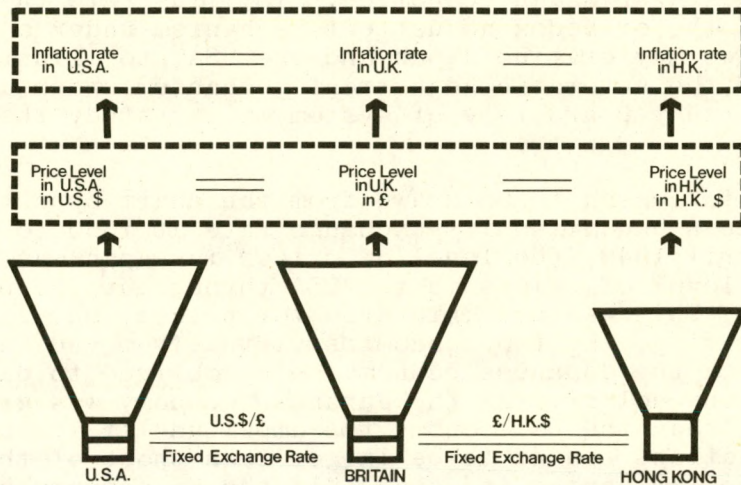
During the post-war years two types of banking system co-existed side by side under the Bretton Woods agreement. For the most part independent nation states had orthodox central banks at the core of their financial systems, with commercial banks operating as customers of the central bank and maintaining reserve accounts at the central bank. Given the adherence to pegged exchange rates by all these central banks, fluctuations in the balance of payments had to be met by the central banks buying or selling foreign currency and supplying or withdrawing a corresponding amount of domestic currency in the form of reserves via the accounts of the commercial banks at the central bank. These fluctuations in commercial bank reserves translated into periods of acceleration or deceleration in the monetary aggregates, which were almost invariably followed by periods of business expansion or contraction respectively. The expansions were typically accompanied by some overheating in the economy and prices would rise more rapidly leading to a deterioration in the balance of payments; the contractions were typically followed by some slowdown in inflation leading to an improvement in the balance of payments. In practice the balance of payments acted as a constraint on excessive expansion or contraction keeping the price levels in different economies from diverging too far.

In the colonial economies which did not have central banks but had some form of Colonial Currency Board system the adjustment process operated to produce the same result (i.e. preventing price levels or inflation from diverging too far), but instead of the process of adjustment being initiated by explicit central bank intervention in the foreign exchange market, the adjustment process occurred without explicit intervention by the authorities - the adjustment occurred "automatically" through the private sector. In most other respects the process of converting external surpluses of the private sector into monetary accelerations and hence into business cycle expansions or booms and the converse process of converting external deficits into business cycle contractions or recessions were identical in colonial economies and in orthodox central bank-type economies.

Obviously there were variations in duration, diffusion, and amplitude of business cycles, but the general process by which stimulatory policies at the core of this whole system (i.e. in the U.S.A.) were transmitted to other central bank systems and colonial economies differed only in the way in which the authorities in any particular economy reacted. In the colonial economies with Colonial Currency Board monetary systems we have shown that the authorities did not enjoy any discretion in the adjustment process and as such the transmission mechanism was 'automatic'. Indeed, insofar as the authorities were only involved to the extent of passively issuing or retiring banknotes in response to private sector demand the

CHART 11

The Old System: Conditions For Success



whole adjustment process was 'automatic' in the sense of not requiring or depending on government action or intervention to initiate it.

Properly defined the term "automatic adjustment mechanism" refers to the maintenance of compatible and consistent price levels in different economies via the Colonial Currency Board system whose central characteristic is the essentially passive nature of its operations, implying in particular an inability to supply or withdraw reserves in the manner of a central bank.

F. How the Orthodox Adjustment Mechanism Worked : Japan and the USA 1949 - 71

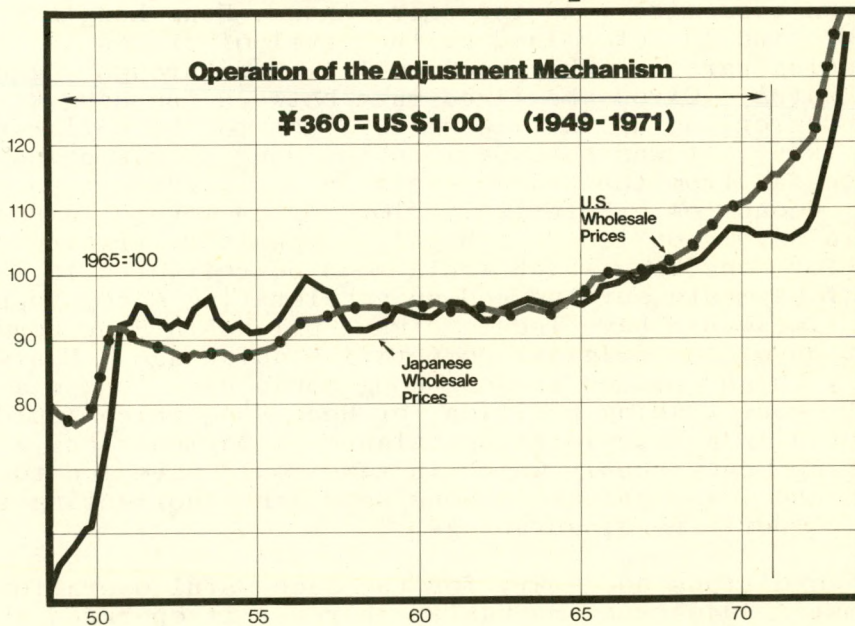
The operation of the adjustment mechanism is best illustrated by reference to some actual examples drawn from the history of post-war Asian economies. To illustrate the operation of the orthodox adjustment mechanism under a central bank system we may examine Japan and the USA; to illustrate the operation of the automatic adjustment mechanism under a Colonial Currency Board type of system we may study the example of Hong Kong.

The basic lesson to be drawn from the chart opposite is that once Japan had fixed its exchange rate at ¥360 to the US dollar in April 1949, the level of prices in Japan was closely tied to the level of prices in the USA throughout the period of fixed rates. This was not only true for prices, but also for economic activity; the two economies virtually moved in step together, with the Japanese economy being obliged to dance to the tune of the dollar. As the Japanese economy was growing more rapidly than the US economy the amplitude of its business cycle fluctuations tended to be larger than those of the USA, hence the popular saying in Japan, "If the US economy catches cold, Japan catches pneumonia".

The mechanism involved in the process of keeping Japanese and American prices in line was a monetary one. If Japanese prices were "too high", Japanese exports would begin to slow down, Japanese imports would begin to accelerate and the balance of payments would switch from surplus to deficit. To make good the deficit and balance Japan's international payments at ¥360 per US\$ the Bank of Japan had to supply dollars by purchasing yen, and in so doing it reduced the reserves of the Japanese banking system, causing the money supply to decelerate. The deceleration of the Japanese money supply led to a slowdown in the Japanese economy, a shrinking of the demand for imports and a decline in the price level. Ultimately as exports became more competitive again, the balance of payments reverted to surplus. Then the converse process would operate, with a balance of payments surplus producing an expansionary monetary policy, and finally a general rise in prices. Thus the obligation of the Bank of Japan to intervene in the exchange market provided Japan with the classic form of adjustment mechanism - a process by which monetary expansions and contractions brought Japan's price level into line with the price level in the United States.

CHART 12

The Bretton Woods System : USA and Japan



G. How the Automatic Adjustment Mechanism Worked : Hong Kong 1952-74

The automatic adjustment mechanism which operated in Hong Kong up until the floating of the exchange rate in November 1974 operated in such a way as to produce effects which were precisely the same as the effects resulting from the orthodox central bank system described for Japan in the previous section. The only difference lay in the mechanism by which the process of monetary expansion and contraction was achieved: in the case of the orthodox central bank system it required explicit intervention in the foreign exchange market while in Hong Kong's modified Colonial Currency Board system no such explicit intervention normally occurred.

To see the effects of the operation of the automatic adjustment mechanism it is only necessary to compare the behaviour of the price level in Hong Kong with the price level in overseas economies. As the chart shows, Hong Kong's price levels were indeed determined by the level of prices in its major trading partners which were all linked through pegged exchange rates. Given the fixed rate between the Hong Kong dollar and sterling up until June 1972 (or the US dollar until November 1974), it was not possible for Hong Kong's price level to deviate far from the price levels in its leading trade partners' economies. Relatively "low" price levels in Hong Kong would have soon led to a highly competitive trading position for Hong Kong which would soon be reflected in a balance of payments surplus and an accelerating money supply which in time would have led to higher prices in Hong Kong and a correction of the original competitive advantage. Conversely, relatively "high" prices in Hong Kong would have led to a disadvantageous trading position for Hong Kong which would soon be reflected in a deteriorating balance of payments and a decelerating money supply which in time would have led to recession and lower prices in Hong Kong, thus correcting the original competitive disadvantage.

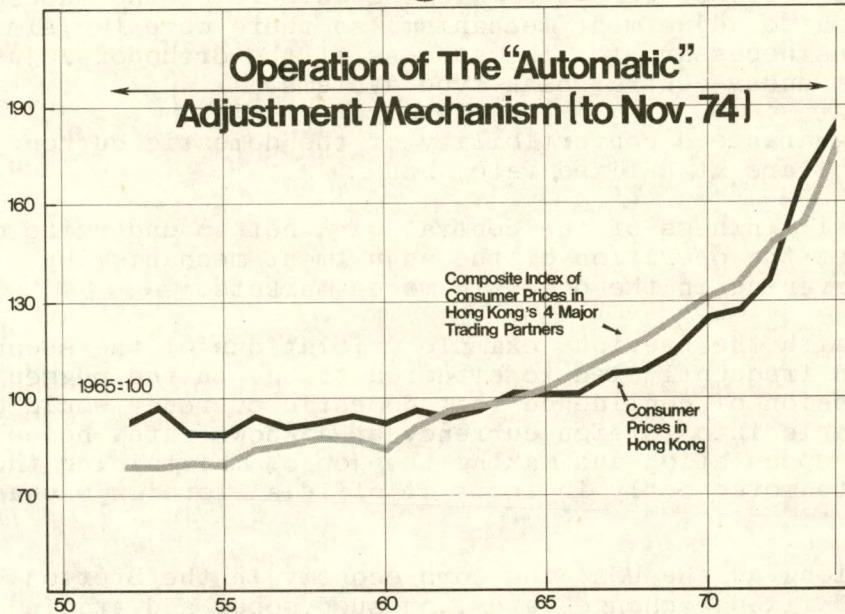
Two conditions necessary for the successful operation of the automatic adjustment mechanism wherever it operated were

- (1) the guaranteed convertibility of the colonial currency into the currency of the metropolitan country at a fixed rate, and
- (2) the inability of the monetary authority in the colony to undermine or offset the operation of this mechanism so long as they lacked the means to intervene either in the foreign exchange markets or the domestic money markets.

In Hong Kong's case the first condition was ultimately violated by the decision to float the Hong Kong currency in November 1974, but essentially that followed from the initial undermining of the second condition in 1972. For in that year the authorities made some crucial changes in the way the

CHART 13

The Bretton Woods System : Hong Kong



monetary system operated. When the decision was taken to abandon the fixed rate against sterling in June 1972 and to adopt a fixed rate against the US dollar, instead of requiring the note-issuing banks to pay for Certificates of Indebtedness (i.e. the authorisations to print banknotes) in US dollars or sterling, the authorities permitted the banks to make payment in domestic currency. Superficially this appeared to give them the means to intervene on either side of the foreign exchange market.* Moreover, the authorities then redeposited that domestic currency back in the banking system, contributing greatly to Hong Kong's monetary explosion in late 1972 and early 1973. Most of Hong Kong's subsequent monetary problems result from the mistakes of policy made at this time. Before returning to the specific case of Hong Kong it is useful to see how the traditional adjustment mechanism broke down elsewhere and how it was replaced with a more satisfactory system because, notwithstanding the chorus of voices to the effect that somehow Hong Kong is different and therefore what applies elsewhere does not apply in Hong Kong, these lessons are particularly relevant to Hong Kong.

* "Superficially" because in reality Exchange Fund intervention operations did not result in the normal multiple expansion or multiple contraction effects. (See AMM Vol. 5 No. 4 pp. 24-29)

H. How the Orthodox Adjustment Mechanism Broke Down : Japan 1971-74

Just as there were two main ingredients of the success of the automatic adjustment mechanism, so there were two similar conditions necessary for the success of the orthodox adjustment mechanism under central bank-type systems:

- (1) the guaranteed convertibility of the domestic currency into US dollars at a fixed rate, and
- (2) the willingness of the central bank not to undermine or offset the operation of the adjustment mechanism by intervening in the domestic money markets.

As with the previous example, violations of the second condition frequently led to either a change in the pegged rate or an erosion of confidence that domestic currency would be exchangeable into foreign currency at a known rate, hence fuelling speculation and making the job of maintaining the fixed rate more costly in terms of official foreign exchange reserves.

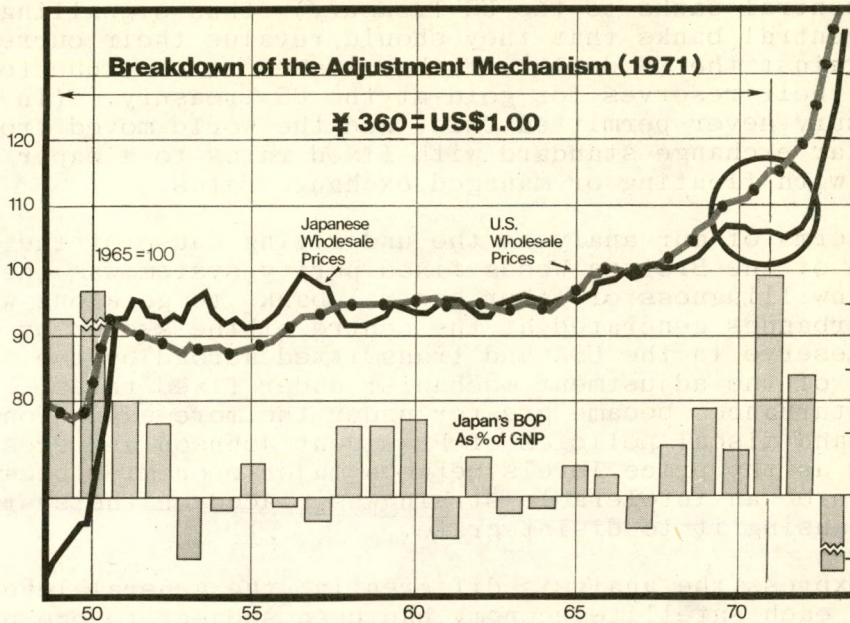
So long as the USA, the core economy in the Bretton Woods system of fixed exchange rates, pursued sober and stable monetary policies there was no serious disruption of other economies. However when in the late 1960s management of the American money supply began to be less stable, larger disturbances in the US economy were transmitted via the fixed exchange rate system to all other economies which maintained pegged rates against the US dollar. The authorities in these other economies faced the choice of either going along with US policies and maintaining fixed rates which would have meant exposing their economies to wide fluctuations in the balance of payments and hence a highly unstable monetary growth pattern, or offsetting to some degree the impact of the balance of payments on the domestic economy by domestic money market operations, or actually altering the parity of the pegged exchange rate.

The West German authorities opted for the third of these courses when they revalued the DM against the US dollar in 1961 and again in 1969.

In Japan, however, the authorities adopted the second course of action. The development of Bank of Japan offsetting actions began in November 1962 with limited purchases and sales of bonds between the Bank of Japan and other financial institutions. These operations were extended in January 1966 with the issue of long term government bonds, and the techniques further refined until by July 1969 the procedures were not markedly different in their effects from standard open market

CHART 14

The Bretton Woods System : USA and Japan



operations.*

In terms of the above two conditions necessary for successful operation of the old system, the Bank of Japan adhered to the first condition but in respect to the second it said in effect, unless we intervene in the domestic money markets to absorb the excess liquidity resulting from the balance of payments, there will be excessive growth of money and credit which will destabilise our economy. As a consequence, instead of inflating with the USA from 1968 onwards, the Bank of Japan resisted by trying to offset external surpluses with sales of bonds in the domestic money markets. As a result monetary growth in Japan was not as rapid as it would otherwise have been, and consequently Japan's wholesale price level steadily diverged from that in the USA so that by mid-1971, despite the fact that the exchange rate remained unaltered at ¥360 per US dollar, there was a gap of more than 10% between the two price levels. With Japanese prices on average 10% lower than those in the USA it was hardly surprising that Japan

* See Yoshio Suzuki, *Money and Banking in Contemporary Japan*, Yale University Press 1980, Chapter 11 pp. 188-195 for a complete description of the development of BOJ offsetting operations. It is clear from Dr. Suzuki's account that the burgeoning external surpluses of the late 1960s and early 1970s acted as a major stimulus on the Bank of Japan in the development of open market operations.

was experiencing enormous balance of payments surpluses.

In a historical sense the breakdown of the Bretton Woods fixed parity system was triggered by the decision of the Nixon administration in August 1971 to close the gold window (i.e. to refuse to pay one ounce of gold for every US\$35 submitted by foreign central banks to the US Treasury), thus signalling to foreign central banks that they should revalue their currencies upward against the US dollar if they wished to continue to exchange their reserves for gold at the US Treasury. (In fact the Treasury never permitted this, and the world moved from a gold-dollar exchange standard with fixed rates to a paper standard with floating or managed exchange rates.)

In terms of our analysis the underlying cause of the breakdown of the Bretton Woods fixed parity system was the general unwillingness of other central banks to go along with the disturbances generated at the centre of the system by the Federal Reserve in the USA and transmitted abroad by the operation of the adjustment mechanism under fixed rates. As these disturbances became greater under the more expansionist monetary and fiscal policies of President Johnson and President Nixon and as the price levels between major economies began to diverge more, an intolerable strain was placed on the system, finally causing it to disintegrate.

To express the analysis differently, the general level of prices in each satellite economy had been subject to one price - namely the fixed exchange rate - via the impact of the balance of payments on the money supply and hence on the general domestic price level. When this system was overturned the leading central banks have gradually moved from a regime of fixed rates with an uncontrolled money supply and an uncontrolled domestic price level to controlling the money supply and hence controlling the overall price level while allowing the exchange rate to vary. The problem in Hong Kong was that when the decision to float was made no corresponding decision was taken to control the money supply, and, as it subsequently transpired when the problem began to be seriously addressed in 1978, the tampering with the monetary mechanism that had occurred in Hong Kong in 1972 meant that no scheme for monetary control could be introduced without radical reforms.

As a postscript it should be noted that having abandoned the external 'discipline' of the fixed Yen-US dollar exchange rate between 1971 and 1973 the Japanese authorities substituted an internal discipline by deciding to control domestic monetary growth from July 1974 onwards. Since that time the Japanese authorities have concentrated almost exclusively on regulating the quantity of money rather than the external price of the yen.

HONG KONG'S MONETARY MUDDLE - THROUGH

Leaving aside the possibility of direct quantitative credit controls, there are three main avenues of approach to the problem of controlling monetary growth.

<u>Lever</u>	<u>Fulcrum</u>	<u>Impact</u>
1. Direct control of bank reserves	Money multiplier	Money supply will grow at a known rate, but interest rates and the exchange rate will fluctuate in response to domestic and foreign economic conditions. Inflation cannot be 'imported' because monetary growth is domestically determined.
2. Managing the exchange rate	Balance of payments	Money supply will grow at varying rates depending on the state of the balance of payments. Interest rates respond to fluctuations in the demand for credit at home and abroad. Inflation will approximate to the inflation rate in the country (or countries) to whose currency(ies) the local currency is pegged.
3. Controlling interest rates	Demand for credit	Money supply will grow at varying rates depending on the demand for credit at the particular interest rate set. The exchange rate will fluctuate in response to the relative demands for credit at home and abroad. Inflation will depend on the money growth rate which will depend on the demand for credit, which in turn will depend on whether interest rates are set too high or too low.

To control monetary growth and hence inflation one can either control the quantity of money via regulating the availability of reserves (1), or the price of money, (2) or (3).

The Hong Kong authorities cannot control bank reserves (1) because the Exchange Fund does not exercise any influence on bank reserves, and Liquid Assets are not amenable to control.

The exchange rate (2) represents the price of money in an absolute and definable sense; it is the quantity of foreign currency which a unit of the domestic currency can purchase at any given time.

Interest rates (3), however, are not such a reliable tool because interest rates are the price of credit (rather than the price of money), and as such they do not ensure either stable growth in the purchasing power of the community as a whole (i.e. the quantity of money) or a stable relationship between the overall level of prices in Hong Kong and the price level elsewhere (as would be achieved by operating a properly managed exchange rate).

In practice the Hong Kong authorities have muddled through by employing interest rates as an indirect method of affecting the exchange rate. As a consequence and in accordance with the theory set out on pp.22-23 - Hong Kong has swung from excessive money growth in 1979-81 to the opposite extreme today.

I. The Hong Kong Monetary System Today

The Hong Kong monetary system today is neither an orthodox central bank system nor is it any longer a variant of the old Colonial Currency Board system. There are three crucial differences:

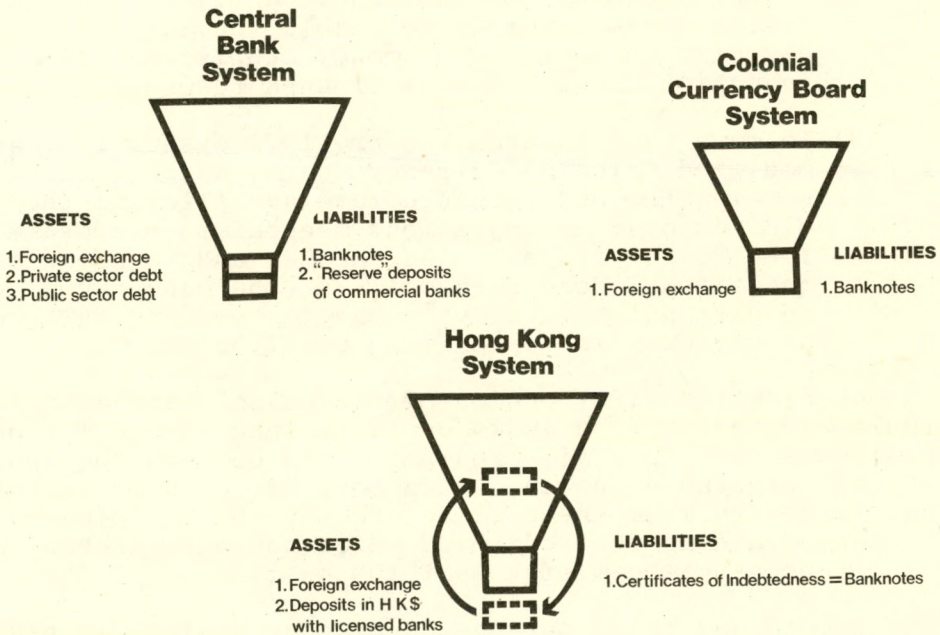
- (1) the value of the currency is not defined in terms of a fixed number of units of sterling or US dollars, and the exchange rate is generally freely floating,
- (2) the note-issuing banks are not required to pay foreign currency in exchange for the authorisations necessary to print banknotes, but they pay in domestic currency, so the issue of currency is not subject to any external constraint, and
- (3) the monetary authorities maintain their accounts with the commercial banks (rather than the commercial banks maintaining their accounts with the monetary authority). This means that instead of being "outside the system" and able to influence the growth of (say) reserves and hence the money supply, the authorities are reduced to being clients of the banking system with little more influence on it (in terms of their transactions) than other major corporations who are also clients of the banking system.

This combination of idiosyncratic features makes it impossible for the Hong Kong authorities to manage the money supply or the exchange rate in a manner which is likely to produce predictable and dependable results, and provides a fundamental explanation for the instability of Hong Kong's financial system. Until reforms are introduced which restore a means of either controlling the money supply directly or managing the exchange rate (and hence regulating the money supply indirectly) it is likely that Hong Kong's financial system will continue to be highly unstable with wide fluctuations in monetary growth over the business cycle.

It is thanks to these idiosyncracies that the Hong Kong authorities have persisted in the belief that, contrary to the experience of the rest of the world, there must be another way out of their difficulties. That other way is via the partial control of interest rates through the Interest Rate Agreement, an arrangement whereby the Licensed Banks set deposit interest rates on deposits under HK\$500,000 and with maturities up to 12 months. To enable foreign banks to participate in this cartel arrangement without becoming liable to Anti-Trust actions in their home countries the authorities introduced the notion of a statutory body, the Hong Kong Association of Banks, to which all Licensed Banks are required to belong. This official legal sanction makes behaviour which some banks would not contemplate at home acceptable abroad.

CHART 15

Where Are We Now?



J. The Options Facing Hong Kong's Monetary Authorities

If it is accepted that the present monetary system in Hong Kong is prone to periodic instability, inappropriate to a major international financial centre, the authorities are confronted with three possible courses of action:

- Either (1) To tinker with the present system in a bid to patch up the flaws and to hope that next time round something will turn up to avoid the embarrassment of repeating the violent monetary fluctuations of 1972-74 and 1979-82,
- or (2) To move towards the introduction of an orthodox central bank in order to enable the authorities directly to control the money supply via the injection and withdrawal of bank reserves,
- or (3) To move back towards the pre-1972 system i.e. a modified Colonial Currency Board, which implies setting the HK\$ exchange rate and allowing the old 'automatic' adjustment mechanism to operate i.e. to set the price of the HK\$ and to allow the quantity of Hong Kong dollars (the money supply) to adjust 'automatically' so as to keep the balance of payments in approximate equilibrium.

In our view the first option offers no solution at all. The problem is that the business cycle is long enough for one Financial Secretary to claim credit for the boom on the upswing and to attribute the downswing to factors beyond his control, and then to retire from the post before the whole cycle repeats itself, thus avoiding the reprimand which he would otherwise incur for repeating the mistakes of the past.

The second and third options have been examined in past issues of AMM, and to date no satisfactory refutation nor any better solution has been offered either by the authorities or - to our knowledge - by anyone in the private sector. The advantages and disadvantages of each option are briefly summarised in the Chart on p.57, but in our view either solution would be preferable to the present structure.

CHART 16

Where Next?

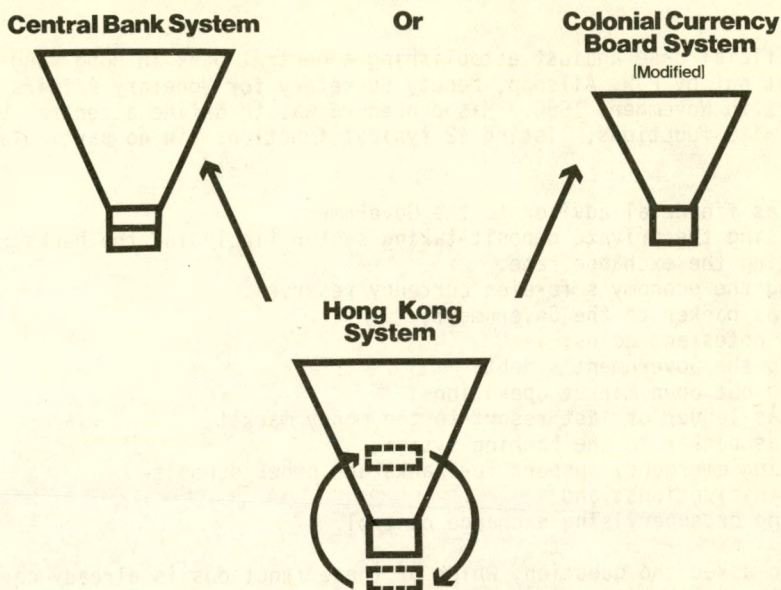
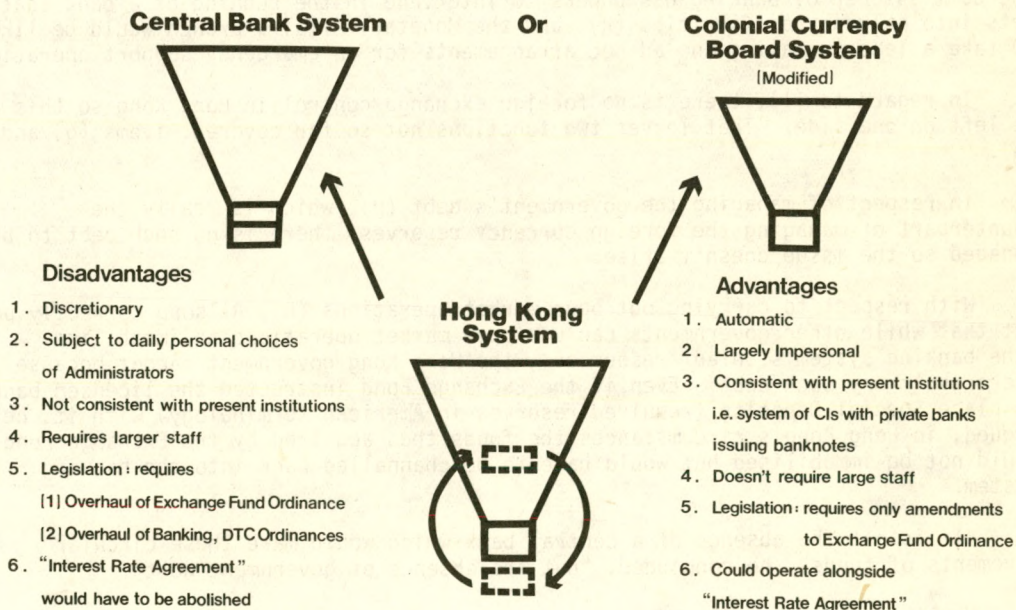


CHART 17

Which is Better ?



CENTRAL BANK OR NO CENTRAL BANK ? A CRITIQUE OF THE OFFICIAL CASE

The official case against establishing a central bank in Hong Kong was formally set out by P.W. Allsopp, Deputy Secretary for Monetary Affairs in a speech on Thursday 27th November, 1980. His procedure was to define a central bank in terms of its functions, listing 12 typical functions (in no particular order of priority):

- (a) acting as financial adviser to the Government;
- (b) supervising the private deposit-taking sector (including the banks);
- (c) regulating the exchange rate;
- (d) managing the economy's foreign currency reserves;
- (e) acting as banker to the Government;
- (f) issuing notes and coins;
- (g) managing the Government's debt;
- (h) carrying out open market operations;
- (i) acting as lender of last resort to the money market;
- (j) acting as banker to the banking system;
- (k) organising emergency support for banks and other deposit-taking institutions; and
- (l) operating or supervising exchange control.

He then asked the question, which of these functions is already carried out by the monetary authorities in Hong Kong? In answer to this he proceeded to demonstrate that almost every function was currently being performed by the Exchange Fund itself (or by the Monetary Affairs Branch of the Government Secretariat, or by the Commissioner of Banking and Deposit-Taking Companies).

In respect of items (a) to (f) the implicit conclusion was that since the Hong Kong authorities already perform all of these tasks, a new central bank as such was not necessary. The Hong Kong and Shanghai Banking Corporation acted as lender of last resort to any particular bank in the money market (i), but the foreign exchange market was the "residual source of liquidity" for the banking system as a whole (j). The Commissioner of Banking has powers to intervene in the running of a bank that gets into solvency difficulties (k), and the Monetary Affairs Branch would be likely to take a lead in making the ad hoc arrangements for an emergency support operation.

In regard to (l), there is no foreign exchange control in Hong Kong so this can be left on one side. That leaves two functions not so far covered: items (g) and (h).

In respect of managing the government's debt (g), which is really the counterpart of managing the foreign currency reserves, there is no such debt to be managed so the issue doesn't arise.

With respect to carrying out open market operations (h), Allsopp correctly points out that while other governments can use open market operations to immobilise "the banking system's unlent resources", the Hong Kong government cannot because there isn't any such debt. Even if the Exchange Fund instructed the licensed banks to place Special Deposits (required reserves in American terminology) with it, he argued, in Hong Kong's circumstances the funds thus acquired by the Exchange Fund would not be immobilised but would have to be channelled back into the banking system.

"It is not the absence of a central bank which would make these circular movements of funds", he concluded, "but the absence of government debt".

Wrong.

Even if H.K. Government debt instruments existed, the movement of funds would still be circular. The reason is precisely analogous to the explanation of why intervention in the foreign exchange market does not work in Hong Kong, (see pp.29-33)

In effect Allsopp's methodology was to ask what were the similarities between the functions of an orthodox central bank and the functions currently performed by the Hong Kong authorities. Instead it would have been more fruitful to have started with the question, what is it that is different about the operations of the Exchange Fund as compared with orthodox central banks?

As explained in the accompanying text the crucial differences between the Hong Kong system and other monetary systems do not so much concern the functions of a monetary authority as the accounting relationships between the authority and the banks, and the consequences which these imply for the banking system as a whole. Specifically:

- (1) Instead of the commercial banks or licensed banks holding HK\$ deposits with the monetary authorities, the Hong Kong monetary authorities hold domestic currency deposits with the commercial banks - the exact opposite to orthodox systems.
- (2) This undermines the multiple expansion or multiple contraction mechanism which is fundamental to the operation of an orthodox central bank system or, for that matter, the traditional colonial currency board system of which Hong Kong's Exchange Fund is a variant.*
- (3) It also effectively relegates the Exchange Fund from the status of an institution which can directly or indirectly control monetary growth to an institution which is on a par with any other large corporation holding deposits in the banking system.

This is what Allsopp refers to as the circular movement of funds consequent upon any operations by the Exchange Fund, and it is this which constitutes the basis for the official policy that it is not feasible to manage the foreign exchange rate or control the money supply.

Correct - insofar as it goes.

But the official conclusion that there is no operational case for the creation of a central bank in Hong Kong is, in our submission, not the end of the story. It is true that so long as Hong Kong has, in Allsopp's phrase, these "rather idiosyncratic institutional arrangements" (whereby the Exchange Fund holds HK\$ deposits with the banking system), the Monetary Affairs Branch or the Exchange Fund is prevented from acting effectively like any orthodox monetary authority to expand or contract the money supply.

However, that begs the whole question of whether these "idiosyncratic institutional arrangements" can, in the light of the events of the recent past, be considered any longer desirable for the long term health of the economy.

In our view these arrangements have not served Hong Kong well, and it is time to review them.

* Multiple expansion or contraction does still occur in Hong Kong through variations in the monetary determinant ratios (D/C and D/R ratios). However with the HK\$ floating the Exchange Fund no longer has the key role in initiating the multiple expansion or contraction process via the balance of payments whereas it used to have the (passive) role of setting the foreign currency price for the HK\$, which in turn directly determined the balance of payments.

5. PROPOSALS FOR A REFORM OF HONG KONG'S MONETARY SYSTEM

In seeking to stabilise the value of the Hong Kong dollar and to reduce inflation in Hong Kong, the Government faces only two alternative basic courses of action.

EITHER the authorities must move to control the quantity of money

OR they must peg the price, that is, the exchange rate of the currency.

Numerous variations on these two alternatives are of course possible, but irrespective of the final course of action chosen, the best solution will be either one or the other, but not a mixture of the two.

Since 1979 several attempts have been made to rectify the flaws in the Hong Kong banking structure, but they have all avoided tackling the quantity-of-money or price-of-money options head-on. On the quantity side the critically important reserve base of the banking system on which Hong Kong's deposit and credit pyramid is erected has been left untouched. On the price side the Hong Kong dollar has essentially been allowed to float quite freely so that the money supply has not been subject to any balance of payments constraint.

Unless further steps are taken to bring the quantity of money more directly under control, these various measures will turn out to have been incomplete. While the government's moves in the direction of controlling interest rates have been welcomed in many quarters, it is by no means clear that controlling the quantity of money (or money supply) via interest rates or via any other means is the best answer for Hong Kong. The question of what is the right solution is the issue we examine here.

The second course of action - pegging the external value of the currency - sounds at first like a return to the pre-November 1974 system when the Hong Kong dollar was pegged to a fixed nominal value of sterling or to a fixed nominal value of the US dollar. However, the drawback of those fixed parity systems was that the value of the foreign currency to which the Hong Kong dollar was pegged proved to be unstable and ultimately resulted in inflation in Hong Kong. The challenge in designing a revised system is to insulate Hong Kong from the consequences of mistaken monetary policies abroad while preserving all the virtues of Hong Kong's open, adaptable, free market economy.

* * * * *

Before setting out our two alternative schemes for reforming the Hong Kong banking system it is necessary to

recognise that the acceptability of any set of proposals will depend largely on the criteria by which those proposals are judged. Without specifying some criteria in advance we run the risk of arousing criticisms which are based not on the explicit mechanisms or instruments we recommend, but on the implicit ends which we seek to achieve. Before embarking on the details of our proposals we therefore enumerate below some of the aims and characteristics which any proposals for reform should have in our opinion.

Premises

1. That the agreed aim of the reformed system should be to stabilise the internal purchasing power of the Hong Kong dollar, i.e. to achieve overall domestic price stability in Hong Kong dollar terms - and thereby to moderate even if not eliminate the extremes of the boom-and-bust cycle to which Hong Kong has been subjected.
2. That the reformed mechanism should take account of Hong Kong's special position in the world economy by interfering as little as possible with free market forces, and should not require or encourage extensive governmental intervention in individual financial markets. This would retain the famed flexibility and adaptability of the Hong Kong economy.
3. That any proposals be compatible as far as possible with the existing institutional framework in Hong Kong, and be impartial as between locally incorporated and foreign incorporated banks.

* * * * *

SCHEME 1: CONTROLLING THE QUANTITY OF MONEY

The best way to control the money supply is through regulating the monetary base. Alternative attempts to control the money supply by direct methods such as placing ceilings on bank lending (or "corsets") have been made in several countries but the drawback with these approaches is that they require extensive governmental interference in the process of determining who shall and who shall not be allowed to borrow. Ceilings discriminate amongst the banks to the disadvantage of the borrowers, depositors and shareholders, and they impose an additional reporting burden on private banks, or additional monitoring costs on the government. But more important, loan ceilings are a bad way of controlling the money supply because they only impact a certain part of banks' assets, and they may not affect total bank credit, especially if banks and businesses are adept at devising new credit instruments.

Control of the monetary base - that is, the reserve base

of credit expansion - is a better method of controlling the money supply because it leaves market forces intact; the allocation of credit among sectors is not distorted and individual banks are free to compete for whatever share of the market they can obtain. By controlling the quantity of bank reserves, control over the money supply can be quite accurate. It is most accurate when banks' eligible reserve assets are directly controllable, and this is best achieved by defining them narrowly as HK\$ liabilities of the monetary authority. This is because the monetary authority can always control the size of its assets or liabilities. For example, if Government debt or short term loans to certain financial institutions (such as the Discount Houses in the UK) are included in the definition of eligible reserve assets, the banks may be able to sidestep a move by the monetary authority to reduce the monetary base by obtaining other reserve assets in place of those being absorbed by the monetary authority.

A narrow definition of reserve assets would obviate three flaws in the present Hong Kong Banking Ordinance. First, it would prevent the banks from being able to create reserves at will as they are currently able to do by borrowing foreign currency. Second, it would end the anomaly which results from translating foreign reserve assets into Hong Kong dollars at the current exchange rate; at present when the exchange rate depreciates the value of bank reserves expressed in Hong Kong dollars increases. Third, it would eliminate the same anomaly which occurs through including gold as a reserve asset; under the current system whenever the exchange rate falls and the value of gold in HK\$ terms rises, to the extent that banks hold gold their reserve assets increase.

The simplest alternative to the current multiple reserve (or specified liquid asset) structure would be to require all licensed banks to hold deposits at the Exchange Fund equal to a fixed proportion (say 5 pct) of their Hong Kong dollar deposit liabilities. The authorities could then control the available quantity of such reserve assets by open market operations in foreign exchange, in government securities, or in commercial bills issued by the private sector. At present the markets in government securities and commercial paper in Hong Kong are still at an early stage of development, and with the tendency of government to run a fiscal surplus there is little likelihood of much growth in this sector, so operations would be concentrated in the foreign exchange market for the time being. As and when markets in private and government sector paper develop the monetary authority could of course extend its operations to these areas. (See box on p.17.)

The attraction of these proposals is that they require minimum alteration of Hong Kong's current institutional arrangements:

1. Private commercial banks could continue to issue bank notes as in the present system. Certificates of Indebtedness (CI's) would continue to be issued in exchange for domestic deposits or foreign assets placed with the monetary authority,

and the three note-issuing commercial banks would continue to issue bank notes against CI's.

2. The government could retain its accounts with the commercial banks as at present. In monetary systems where the government's deposits are maintained at the central monetary authority and not at the commercial banks the irregular pattern of tax collection and expenditure causes fluctuations in the volume of credit creation by the commercial banks unless deliberate offsetting action is taken. The advantage of the government keeping its accounts with the commercial banks as at present is that these disturbances would be avoided.

3. Supposing there was a change in policy resulting in the Hong Kong Government shifting to a persistent budget deficit, it would be highly desirable if the automatic monetisation of this debt could be prevented, thus avoiding the inflationary effects of such a policy. Provided the government maintains its fiscal accounts at the commercial banks it is in an analogous position to ordinary corporate entities: if it experienced a cash deficit it would have to borrow temporarily from the banks, or the public. In neither case is new money created. But if the government maintained its accounts only with a monetary authority the temptation to finance the deficit by creating the necessary new funds whenever the need arose would be substantially greater. In other words the privileged position of the government would make it more difficult for the monetary authority to resist financing short term government requirements by simply printing the money. Our proposals do not place the government in any such privileged position.

The main disadvantage of these proposals is that although the structure of the revised banking system and the Exchange Fund (see also box on pp.64-65) is easy enough to set out, the operating procedures for the monetary authorities are much more difficult to define and much more difficult to reconcile with our criteria of non-intervention and impartiality. In the first place it has to be decided at what rate the reserve base of the system should be allowed to grow, and it is by no means easy to select the rate which would be right for Hong Kong's changing circumstances.* Meanwhile there would be the clear danger of overshooting or undershooting the appropriate rate with accompanying disruptions to the domestic economy. Second, once it was clear that the authorities had discretion to influence interest rates and exchange rates in the short run, no doubt political pressures would build up in favour of offsetting each disturbance that happened to occur, and before long the officials operating the monetary authority would face substantial temptations to interfere. Even if they acted with the best of motives, their powers to interfere would be enormous, and it is doubtful if they would long be able to resist the political pressure to "do something" for various pressure groups (e.g. exporters, home-buyers, or wage-earners).

* Technically the right rate requires calculating the demand for money function etc.

LEGISLATIVE CHANGES REQUIRED TO CONTROL THE MONEY SUPPLY

Effectively to control Hong Kong's money supply, two sets of actions need to be taken:

- (A) Redefine the reserve base and its relation to deposits.
- (B) Provide for effective control of the reserve base.

The first step requires amendments to the Banking Ordinance,* while the second requires alteration of the Exchange Fund Ordinance.

A. Redefining the Reserve Base

A serious flaw in the present Banking Ordinance is that licensed banks can create liquid assets at their own discretion simply by borrowing foreign funds from overseas correspondent or associated banks, and depositing those funds abroad at short term.

If it is decided to control the quantity of Hong Kong dollar money supply, then the reserve base must be defined in such a way as to make control feasible. The simplest way to do this is to require all banks to hold a fixed percentage of their Hong Kong dollar deposit liabilities in the form of currency and deposits at the Exchange Fund (see below). Because the Exchange Fund would have the ability to alter the level of reserves in the system, the authorities would thus acquire direct control over the reserve base and hence over the money supply. It is important that the revised definition of reserves does not include any assets which are not liabilities of the Exchange Fund because this will impair the ability of the authorities to control the growth of the reserve base.

B. Controlling the Reserve Base of the Banking System

To provide effective control of the reserve base of the banking system while preserving the system of private note issue the following modifications could be introduced:

Assets of the Exchange Fund

- (1) Prohibit the Exchange Fund from holding HK\$ deposits with commercial banks in Hong Kong, but require all licensed banks to hold accounts with the Exchange Fund. (See (4) below.) N.B. The Exchange Fund could still hold foreign currency deposits.
- (2) The Exchange Fund could hold (a) foreign assets of any kind (these would mainly be foreign government securities) or (b) Hong Kong \$ denominated private

* All statements about banks on these two pages apply also to DTCs.

sector instruments or (c) Hong Kong Government or government-guaranteed debt instruments.

Liabilities of the Exchange Fund

- (3) The Exchange Fund would continue to issue CIs to the commercial banks, and the banks would pay for them either with foreign assets or by debiting their reserve accounts with the Exchange Fund (see (4) below).
- (4) Require all licensed banks to hold reserve deposits with the Exchange Fund. The Exchange Fund could vary the quantity of total bank reserves by buying or selling any of the assets in (2) above, and its objective would be to make this total grow at a specified rate which might be varied annually or semi-annually. The interest rate used for 2(b) or 2(c) could be set by reference to the interbank rate, but it would be important to ensure that this rate never became an objective of policy. Settlement of any HK\$ cheques drawn on or payable to the Exchange Fund would be settled through crediting or debiting the accounts of commercial banks at the Exchange Fund. Such transactions would directly affect the reserve base and banks would have to adjust their lending to keep their reserve/deposit ratios on target.
- (5) Capital Accounts and retained earnings of the Exchange Fund. Since the Exchange Fund will be holding substantial earning assets against almost costless liabilities, it will make sizable profits. As with central banks elsewhere in the world, the seignorage or earnings above a fixed limit could be transferred to the government's fiscal accounts on a specified annual, semi-annual, or quarterly basis. This would be consistent with the objectives of the Exchange Fund as set out in the Exchange Fund Ordinance (Cap. 66 Section 3) that the Exchange Fund "shall be used for the purpose of regulating the exchange value of the currency of Hong Kong". To put it another way, the objective of the Exchange Fund would not be (nor ever should have been) to conduct its operations so as to maximise profits. (It could of course very easily do so by expanding its balance sheet, thus expanding Hong Kong's reserve base and hence the money supply, but clearly this would be detrimental to our objective of stabilising the internal purchasing power of the Hong Kong currency.)

Other Accounts of the Exchange Fund

The Exchange Fund would no longer hold HK\$ deposits with the commercial banks in Hong Kong. Outside Hong Kong it would of course be permitted to maintain foreign currency and custodian accounts with banks or any appointed agents.

SCHEME 2: CONTROLLING THE EXCHANGE RATE

The major disadvantage of Scheme 1 is that the guidelines for monetary policy are uncertain and left to the discretion of the administrators. There are few checks to ensure that the monetary policy is compatible with long-run price stability. Through error or design the rate of growth of the money supply may deviate from the rate required for long-run price stability - but the consequences of such deviations will not become apparent in the economy until several months or even years later. In other words the feed-back to the monetary authorities of the consequences of their policies is delayed.

This is of course a problem faced by all countries whose monetary authorities aim to control the quantity of money. Like the pilot of an oil tanker, the authorities may not realise the ship is running onto the rocks until it is too late to change course. There is a danger that monetary policy will oscillate between over-expansion and over-correction with the consequent familiar stop-go effects on economic activity.

If instead of using economic indicators within the Hong Kong economy as guidelines for monetary policy an 'external' rule could be devised to regulate monetary expansion then the tendency for monetary policy to waver in response to the consequences of earlier mistakes would be avoided. To extend the analogy, if the only guide for steering the oil tanker is a light on the bow, then the man at the helm will be aiming at a target which moves in response to his own actions and the ship will wander erratically on the ocean. If instead the helmsman could aim for a lighthouse on the horizon, then his course would be steady, and his target would be independent of the movements of the ship.

In the 1960's the lighthouse was a fixed rate of the Hong Kong dollar against Sterling. The Exchange Fund bought and sold foreign exchange in whatever amounts were necessary to keep the exchange rate fixed. The money supply adjusted, and the price level in Hong Kong also varied, but the automatic consequence of the pegged exchange rate was that the price level in Hong Kong in the long-run followed the price level in the UK.

The target of the Exchange Fund was neither the domestic price level, nor the money supply nor interest rates (which were all like lights on the bows of the ship), and these variables were all left to market forces, but nevertheless the long-run trend in the price level was effectively linked to the trend in prices in the UK.

The problem with the pegged exchange rate was that the currency to which the HK dollar was pegged was not inflation-proof: as first the pound sterling, then the dollar succumbed to inflation the HK dollar was dragged into the same mire. If the HK dollar could be pegged to a currency which was guaranteed inflation-proof then HK would also be free from inflation. Although from time to time a few countries achieve virtual

price stability for short periods there can be no assurance that they will continue to follow non-inflationary policies in the future, so an alternative might be to adjust the peg for inflation in the other currency.

As an example, and only as an example, suppose the Exchange Fund were to follow a rule that it must aim to keep the purchasing power of the Hong Kong dollar constant in terms of the commodities comprising the wholesale price index in the USA. Then the Fund would buy and sell US dollars at an exchange rate which moved at the rate of increase of wholesale prices in the USA. Suppose at the beginning of the year the exchange rate of the HK\$ was HK\$5.00 = US\$1.00 and the rate of inflation in wholesale prices in the USA is estimated at 10% per annum, then the Exchange Fund should guide the Exchange Rate to HK\$5.00 = US\$1.10 by the end of the year or HK\$4.55 = US\$1.00. If this guideline is followed then in the long run prices in Hong Kong, adjusted for exchange rate changes, cannot move far out of line with prices in the USA. Since the exchange rate of the Hong Kong dollar rises at the same rate as US prices this ensures that long-run price stability is maintained regardless of the inflation rate in the USA.

There are a number of problems associated with this policy:

Firstly, wage/price controls, exchange rate manipulations, political instability and many other factors can distort the US wholesale price index and/or the exchange rate of the currency with third countries against which the Hong Kong dollar is to be compared. To minimize these dangers, the single currency could be replaced by a basket of currencies each appropriately adjusted for inflation, so abnormalities associated with any one currency would have less effect.

Secondly, the appropriate measure of inflation in each currency is open to debate: should it be a wholesale price index, consumer price index, export price index or GNP deflator or some combination of these? This is really not a serious problem. The world is not perfect and inflation is an imprecise concept; as long as some index is agreed upon and the guideline followed, inflation in Hong Kong will be negligible.

Thirdly, a more sophisticated approach would be to use 'expected inflation rates'. Since inflation responds only with a lag to excessive monetary expansion, adjusting merely for present inflation rates would not prevent excessive monetary growth overseas generating a monetary explosion in Hong Kong and a subsequent inflation. Though the price rises would be eliminated eventually by the exchange rate policy the inflation and subsequent deflation would cause unnecessary instability. By adjusting the exchange rate relative to expected inflation rates i.e. with regard to monetary policy in other countries and not merely their current inflation rates such disturbances could be reduced. The estimation of expected inflation rates would however involve personal judgments and subjectivity which would reduce the 'automatic' nature of the system. This

problem would also be reduced by including a large number of currencies in the basket, so the leads and lags of monetary policy and inflation in any one country would have less effect on the Hong Kong economy.

Fourth, the appropriate disclosure policy must be carefully considered. Would announcement of the exchange rate policy rule lead to speculation and exchange market instability as operators try to out-guess the authorities? Most countries which 'peg' their currencies to a basket do not disclose the weighting of the currencies in the basket or their precise policy of intervention on the foreign exchanges. There is considerable and mounting evidence that both Singapore and Switzerland have adopted policies similar to the proposals outlined here and they have also maintained a deliberate policy of vagueness and secrecy with regard to their exchange rate intervention.

It is not intended to give a detailed description of the 'real exchange rate' proposal here, but merely to discuss the issues involved. As far as we can judge it requires very few changes to the existing monetary system.

1. The Exchange Fund must revert to the situation of the 1960s when only foreign currency assets could be held by the fund. In order to issue new banknotes the commercial banks would have to submit foreign currency at the exchange rate announced by the Exchange Fund, in return for Certificates of Indebtedness. The commercial banks would no longer be able to submit Hong Kong dollar deposits.
2. The 'real exchange rate' system requires no change to the existing specified liquid assets system described in the Banking Ordinance. Though far from ideal the existing arrangements are irrelevant to the operation of the 'real exchange rate' system.
3. There would be no need to set up a new monetary authority or increase the powers of the Exchange Fund; there would be no need for controls on interest rates or credit expansion since these would be regulated by the balance of payments. In effect Hong Kong would return to the automatic adjustment mechanism which operated until 1974, only this time the Hong Kong dollar would be pegged to an artificial inflation-free currency.

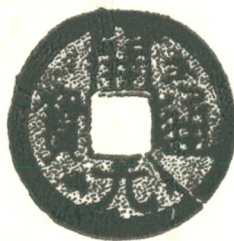
SUMMARY AND CONCLUSION

In order to stabilise the domestic purchasing power of the Hong Kong currency and stop inflation, while at the same time preserving the free market strength and adaptability of Hong Kong's economy and maintaining the present institutional structure, the monetary authorities can either control the money supply or peg the currency.

If they choose the former, this brings with it the danger of more extensive government intervention, and it will certainly

require some institutional changes if it is to work successfully. If they choose the latter - pegging the exchange rate - it will be important to peg to an artificial unit of stable value rather than to a nominal foreign currency of unreliable value. At the same time it will be essential for the authorities to abandon any attempt at controlling the money supply because of the logical impossibility of both pegging the currency and controlling the money supply.

At present, however, the authorities are neither effectively controlling the money supply nor pegging the currency to a stable unit of value. Unless further action is taken along the lines suggested here it is more than likely that Hong Kong will again experience the same pattern of excess money and credit creation followed by an abrupt curtailment of money and credit growth whereupon an overheated economy, and booming stock and property markets will give way to a sudden downturn in economic activity, and a collapse of equity and property prices. A decision in favour of the status quo implies a vote for a rerun of recent history-not an attractive path down which to steer the Hong Kong economy, but unless there is some fundamental rethinking which yields some soundly-based proposals for reform, Hong Kong is destined to repeat the excesses of the last few years over the course of the next business cycle.



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